# The role of the regulator, auditor and banker: The limits of regulation

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Signature..........................

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*This work is dedicated to my Father thank you for your wisdom and encouragement*

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## Abstract

Occasional academic works have discussed the new developments in the supervision and control of the London Capital Market, but no consolidated work has previously analysed the holistic approach of the Financial Services and Markets Act 2000 (FSMA 2000) or the operations of the single controller and regulator, the Financial Services Authority. This work compares the Bank of England's and the Financial Services Authority's regimes to argue that: The supervision of banks and credit institutions is necessary for ensuring a system of prudential banking in which there is risk minimisation, financial stability of markets and protection of investors and depositors. The growth of financial conglomerates has required a holistic approach to the monitoring and control of risk in the banking industry and to the provision of protection for consumers. It is apparent in the evolution of the banking and financial system that market forces made the single regulator inevitable. In the process of this argument there is detailed analysis of financial-stability issues, the prudential supervision system under FSMA 2000 (focusing particularly on solo and consolidated systems of supervision), the system of corporate governance, the enforcement-style and sanctions that govern banking supervision, and the system of accountability for auditors and regulators introduced by FSMA 2000.

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## Introduction

The purpose of banking supervision is primarily to ensure financial stability, and secondly, to safeguard depositors' interests. Traditionally, banking supervision has concentrated on monitoring and controlling credit risk. More recently, controls have centred upon the monitoring of counterparties, domestically and internationally, through 'solo' and 'consolidated' supervision. These measures are underpinned by a number of complex standards to ensure that banks have an adequate amount of capital to protect them against counterparty losses. This has been the driving force behind the capital-adequacy rules. However, the market today is very much intertwined and complex, giving rise to bank-financial conglomerates which are exposed to credit risk, market risks and risks from insurance business.

This work is based, principally, on primary sources of information and it performs an inter-disciplinary analysis of institutions that are authorised to undertake deposit-taking business. Prudential supervision of authorised institutions requires an inter-disciplinary approach. Thus, the perspectives considered are the diverse ones of economics, political science, criminology and business. These perspectives are presented interchangeably to illustrate the aspects of prudential supervision examined in this work. It is important also to integrate broad-policy considerations, such as financial stability and depositor protection to analyse the reasons that render prudential supervision necessary. This multiplicity of perspectives has resulted in Chapters that, though apparently independent, are in fact necessarily interdependent as an analysis of bank-prudential supervision.

Chapter One explores the main drivers for a single regulator of UK capital markets. It attempts to examine the evolution of banking and financial regulation by focusing on the role of the Bank of England (the Bank). The examination of regulation focuses initially on the macro- and micro-economic forces that have shaped the way banks operate in capital markets. No examination of the evolution of banking and financial regulation can be undertaken without a scrutiny of bank failures: they have played a significant role in identifying the limitations of regulation and supervision. Moreover, the liberalisation of the securities business led to the growth of banks' securities businesses, and consequently, of bank-financial conglomerates. Finally, the issues explored yield the gamut of reasons that made the single-regulator inevitable.

No examination of prudential supervision can take place without an exploration of the importance of financial stability. Such an examination occurs in this work's analysis of the role of the Bank of England and the Financial Services Authority. This analysis places particular emphasis on the Bank's role as the Lender of Last Resort, and on the Deposit Insurance Schemes. It asserts that prudential supervision is the mechanism that attempts to reduce moral hazard and social cost, the typical 'fall-out' attendant upon bank failures. The role of the Financial Services Authority is explored also, and an attempt is made to analyse the objectives of regulation, such as the maintenance of market confidence and the protection of consumer interest. Arguably, the formal objectives of the Financial Services and Markets Act 2000 (FSMA 2000) existed informally in the pre-Act regime.

Chapter Three analyses the legal aspects of prudential supervision in the UK by defining 'supervision', 'surveillance' and 'prudence'. Attention is then given to the impact of competition policy and the role of Basel and the European Union. An analysis of 'authorisation' and the criteria to be fulfilled by respective institutions is offered. It is conceded that though the underlying policy of allowing cross-authorisation has led to the growth of bank financial conglomerates, problems created by the resultant multiple authorisations have been resolved by the FSMA 2000.

However, it is perceived that there remains a need for provisions that mitigate counterparty loss. For this reason, emphasis is placed on the need to devise appropriate prudential measures by means of capital-adequacy rules. The recent spate of bank-securities failures has turned attention to issues relating to corporate governance, the foundation of safe banking. The autonomy of the institution is sacrosanct, and the costs and burden of regulation are traditionally the main drivers in limiting the weight of regulation. In Chapter 4 it is argued that effective corporate governance is essential for reducing the likelihood of future failures. Emphasis is given to the role of the audit committee and internal audit function. Furthermore, particular significance is placed on the duty of directors and the consequence of non-compliance, which is debarment from that office. Chapter 5 analyses the enforcement methods and style of the Bank and the FSA under the Banking Act 1987 and the FSMA 2000. Chapter 6 examines the contribution by auditors to the prudential supervision of banks. It is shown that they have two roles, and that those are conflicting roles because one serves the interest of the institutions that employs them, and the other the regulator's purposes. This is further exacerbated in the reporting-accountant role, in which there is an implicit duty to the regulator to take reasonable care. It is argued that this duty needs to be formalised and the provision of non-audit services needs to be monitored more carefully by the regulator to reduce the conflict with regulatory objectives.

Chapter 7 addresses the issue of regulator accountability. While regulators are deemed experts, they are obviously prone to human error. Some errors can be considered to be errors born of negligence, and in the worst-case scenario, of *mala fide*. While it is too early to say whether the FSA is effectively more accountable than the Bank, the introduction of the Consumer and Practitioner Panel, the single Ombudsman and Complaints Officer do suggest that the FSA is more accountable to consumers as depositors than its predecessors. However, the FSA, like the Bank, is immune from civil suit, except on a charge of misfeasance in public office.

Overall, the importance of trust and co-operation are emphasised where the majority of banks are compliant. The opacity and rather limited enforcement action led to criticism of the Bank. However, enforcement action in the case of banks requires sensitivity to the possibility of bank runs and the financial instability consequent upon them. It is apparent in an analysis of the enforcement statistics published by the Bank that punitive sanctions lead to over-accommodation of non-compliance, and that negotiation rectifies it. While the latter method has been successful in reducing the number of bank closures, moral hazard can nevertheless ensue because it protects the reputation of an institution in the market.

The creation of more rules does not necessarily ensure compliance, but a more vigilant and sceptical approach in the existing order is encouraged. It is argued that consumer/depositor interests may have displaced financial stability as the backbone of prudential supervision. A major obstacle in this direction is the traditional focus on institutional-safety measures rather than on conduct of business rules.

# Chapter 1

# The Evolution of Banking and Financial Regulation

## 1.1 Introduction

Banking supervision evolved from its starting-point in an informal network of relationships between the central bank (the Bank of England) and a relatively small banking community. This network of banks and financial institutions grew in complexity and came to require a formal system of supervision. The liberalisation of the UK capital markets during the decades after the post world war period brought into being a sophisticated web of diverse bank-financial conglomerates. Their sustained growth exposed a number of problems, not least of them, being the overlap of regulatory responsibilities. Overlap occurs when regulation is conducted in the context of common processes of: authorisation, supervision, enforcement and accountability. The process 're-regulation' emanates from the introduction of the 'single regulator'. To understand the mechanics of either, it is important to engage in an examination of the evolution of banking supervision and securities regulation. The businesses of banking and securities are two key interdependent industries. The Bank was the main architect of their culture of supervision and regulation.

In this chapter, section 1 focuses on the importance of financial regulation as an instrument of economic policy. Section 2 looks at the evolution of banking supervision with emphasis on bank failures and at the reactive legislation introduced to reduce the likelihood of future bank failures. The developments in banking supervision during the post-Banking Act 1987 period, (after the collapse of BCCI and Barings bank) shifted attention towards improving prudential supervision and away from the erstwhile preference for overhauling legislation. An attempt is made to highlight the continuing importance of moral persuasion as the central mechanism of supervision. Section 4 focuses on the Bank's role in the UK capital markets. Section 5 and 6 examine the growth of bank-financial conglomerates, focusing on the broad range of financial activities undertaken by such institutions. Section 7 draws the strands together to provide a backdrop for the 'single regulator'.

## 1.2 Competition Policy & The Economy

Economic policy underpins the regulation of financial institutions and the legal regulation of those institutions is an instrument of economic policy.[1] Economic policy is divisible into two broad categories: micro-economic policies to enhance efficiency of allocating resources; macro-economic policies to ensure economic stability. These broad categories are not mutually exclusive nor are the specific components of those policies. Rather they interrelate to enhance *inter alia* efficiency in the banking system. Regulation, of banking business whether *de facto* or *de jure*, has been used by governments' to control and influence business activities. This makes the examination of policy issues somewhat problematic. Nevertheless, it is still important to understand how the particular policy considerations have shaped the banking and financial system.

Traditionally governments have attempted to manage the economy by *de facto* or *de jure* collective agreements reached with trade associations on interest rate and price controls. The growing influence of monetarist economics, which attached more importance to control over the supply of money changed this policy. Competition and Credit Control was introduced in 1971 (CCC).[2] The policy of CCC, dismantled credit ceilings and introduced market mechanism as the manager of money supply and interest rates.[3] The catalyst for this policy change was the collapse of the Bretton Woods system of fixed exchange rates. According to Geisst, some of the significant financial events in Britain in the 1970s were directly attributable to the collapse of the tradition of collective agreement.[4] The introduction of CCC provided the initial building blocks for enhanced competition among participants in the banking industry: This was brought about by the abolition of interest rate controls, limits on capital movement and the dismantlement of barriers to participation in other parts of the UK capital markets.

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[1] T Daintith, 'Law as a Policy Instrument: Comparative Perspective', in T Daintith, *Law as an Instrument of Economic Policy: Comparative and Critical Approaches*, Berlin De Gruyter (1988) 3-47 at p. 6-19; D Gowland, *The Regulation of Financial Markets in the 1990s*, Aldershot Edward Elgar (1990) at p. 21

[2] K K F Zawadzki, *Competition and Credit Control*, Oxford Basil Blackwell (1981) at p. 33; J Grady and M Weale, *British Banking, 1960-1985*, Basingstoke Macmillan Press ltd (1986) at p. 51; F E Perry, *The Elements of Banking*, London Methuen & Co ltd (1975) at p. 41

[3] Ibid., K K F Zawadzki, (1981) at p. 127

[4] C R Geisst, *Exchange Rate Chaos: 25 years of finance and consumer democracy*, London, Routledge (1995) at p. 3

In the UK, monetary and competition policy was influenced by the entry into the European Economic Community. The original Treaty of Rome envisioned a single integrated market.[5] The impact of the single market programme on the provision of financial services emanates from the wider European Community efforts towards establishing a single economic market. The first step in the development towards a single market in the financial services industry was the dismantlement of barriers that had prevented the free movement of capital. In this single market vision, the financial services sector was just one area that required attention to ensure that the European financial market retained its competitive position and in turn facilitated the growth of the service industry to the Community's economy. The progress towards a single market for the financial services industry was rather slow in comparison with growth in other areas because of the high level of regulation to which it was subject.

The White Paper proposed a system of 'minimum rules' within the European Community to regulate credit institutions, authorisation, financial supervision and winding-up procedures. The conceptual basis of the internal market was based on the idea of 'mutual recognition' amongst the Member States. This was the principle of 'home country control' where the 'host country' retains limited powers to supervise credit institutions. The White Paper highlighted the necessity of prudential measures with regard to adequate own funds, solvency and liquidity ratio, and the monitoring of large exposures. Credit institutions were required to comply with the 'minimum standards' set by the home Member State. The European harmonisation programme for the financial services sector incorporated a common 'banking model' referred to as the 'Universal Banking Model', which integrates bank and non-bank securities business.

The programme for harmonisation was never considered easy, given the diversity of banking and regulatory styles. The diverse economic and cultural differences among Member States exacerbated the strategic problems of the harmonisation programme: efforts to meet EC requirements might result in an adverse exposure of some Member States' banking industries; intensification of competition

[5] Commission to the European Council, *Completing the Internal Market White Paper,* Brussels Commission to the European Council (1985) Com (85) 310 final

could result in a loss of market share to rival Member States.[6] In White's[7] view, intensity of competition was likely to have more detrimental effect on Continental banks than on English-speaking countries, because many Continental banks lacked the necessary technology to develop new and sophisticated financial instruments. The role of the state in many Continental European countries is another factor: In France, Italy and Germany a large proportion of the banks are in one-way or another subject to state control.[8]

The Maastricht Treaty and the adoption of a single currency in 1999 changed a number of economic and monetary objectives. The introduction of the single European currency was achieved with the adoption of the Treaty of the European Union (Maastricht Treaty).[9] Monetary Union made fundamental changes to the way monetary policy can be decided in a Member State. It required: dismantlement of all barriers to the movement of capital; convergence of the Member State economies in accordance with specific 'convergence criteria'; the tying together of currencies to introduce the *Euro* as the common currency. The program for monetary union provides for a European System of Central Banks (ESCB) and the European Central Bank (ECB).[10] In the context of central banking, the creation of economic and monetary union was significant because it transferred decision-making to the European Central Bank on monetary policy and price stability.[11] The impact of monetary union is clearly visible in Britain even though it has opted out of the single currency.[12] For example, the EC Treaty, advocated the independence of Member State central banks' which necessitated autonomy for the Bank of England.[13]

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[6] D T Llewlellyn, 'Banking and Financial Services', in D Swann, *The Single European Market and Beyond: A study of the wider implications of the Single European Act*, London Routledge (1992) at p. 138

[7] W R White, *The Coming Transformation of Continental European Banking?*, Working Paper No. 54, Basle Bank for International Settlements (1998) at p. 4-9

[8] Ingo Walters, 'Capital Markets and Control of Enterprises in the Global Economy', in S S Cohen and G Boyd, *Corporate Governance and Globalisation: Long Range Planning Issues*, Cheltenham Edward Elgar (2000) at p. 100-117; for examination of the liberalisation of domestic financial markets in the Danish, French, German see: G Morgan and D Knights, *Regulation and Deregulation in European Financial Services* Basingstoke Macmillan Press Ltd (1997)

[9] For an examination of Britain's position on EMU see: F Giordano and S Persaud, *The Political Economy of Monetary Union: Towards the euro*, London Routledge (1998) at p. 159-177

[10] EC Treaty Article 107. See also R M Lastra, 'The Independence of the European System of Central Banks', Vol. 33, No. 2, *Harvard Law Review* (1992) 475-519

[11] Article 105(1)

[12] Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community* June (1988) (Delors Report)

[13] Chapter 2 The Role of the Bank of England and the Financial Services Authority at p. 37

### 1.3 Banking Regulation and Supervision

Banking regulation and supervision in Britain has gone through several transition periods. Moral [per]suasion informal and formal had been a cardinal part of its style of supervision.[14] Moral persuasion acted as the instrument of regulatory control and provided the context for trust and co-operation between the Bank and the City of London (the City).[15] The need to meet the Government's obligations under the EEC First Banking Directive[16] and the Second Banking Directive was the catalyst for important operational changes.[17] A separate formalised system of regulation and supervision was introduced with the passing of the Banking Act 1979 (repealed by the Banking Act 1987). The style of banking supervision within these transition periods has had turbulent times visited upon it by the various exigencies of economic policy: an increased number of participants within the financial markets (domestic and foreign); periods of significant financial instability; technological innovations; and the collapse of banking institutions. Notwithstanding the changes and the evolution of prudential supervision, the discretion-based style of supervision continued to be encouraged.

The autonomy of the Bank in the early part of its history was one of its key bargaining powers. This provided its influential relationship with the state. Class and educational ties traditionally maintained the social cohesion of the City of London.[18] Moral persuasion acted as a mechanism that ensured compliance because 'recognition' allowed the institutions to exercise their restrictive practices.[19] The Bank played a significant part in making the 'City of London an attractive place to do business by promoting its competitiveness'. This was done through the unique culture of regulation and supervision, which it advocated.

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[14] First Report from the Select Committee on Nationalised Industries Session (1969-70) Special Reports, London, HMSO at p. xxv, para., 69-81

[15] Ibid., at p. xxvii-xxx, para., 82-90

[16] First Council Directive 77/780/EEC on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.

[17] Second Council Directive 89/646/EEC on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.

[18] D M Meerschwam, *Breaking Financial Boundaries: Global Capital, National Deregulation, and Financial Services Firms*, Boston Harvard Business School Press (1991) at p. 162

[19] M Moran, *The Politics of the Financial Services Revolution*, MacMillan Publishing, London (1991) at p. 63

The Bank, from its inception, developed strong relationships with the other bankers (the goldsmiths).[20] Its relationship with commercial banks was somewhat chequered. In the early days, the Bank gained its unique position at the expense of commercial banks losing important parts of their business such as note issuance. [21] The Bank's limited liability enabled it to strengthen its position sufficiently to secure its unique role as the Government's personal bank and the banker to banks. The establishment of the Bank as the key supplier of money to the financial community gave it the ability to control the 'reserves' of the banking community.[22] Furthermore, its influence gave it the capacity to be 'Lender of Last Resort', even though it had no legal obligation to be that.[23]

Section 4 of the Bank of England Act 1946 achieved the first formal codification of banking regulation. This section of the 1946 Act was, at the time, rather controversial.[24] The ambiguity of s. 4(3) was considered a threat because it gave the Bank power to request almost anything in the national interest.[25] The provision was essentially directed at the clearing banks merely legalising an already existing relationship between the Treasury and the Bank.[26] The privilege it conferred was never used, even though it provided a gateway for the Bank to become the supervisor of the activities of all banks within the capital markets.[27] Moral persuasion, within the remit of s. 4(3) required a significant amount of coercion. The banks' were not always co-operative and on some occasions, they were reluctant to part with

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[20] J Clapham, *The Bank of England, A History 1694-1914*, (Vol. I, 1694-1797 & Vol. II, 1797-1914) Cambridge Cambridge University Press (1944), *Vol I*, at p. 10

[21] F Capie, C A E Goodhart, S Fisher and N Schadt, *The Future of Central Banking: The Tercentenary Symposium of the Bank of England*, Cambridge Cambridge University Press (1994) at p. 63. According to Congdon: "central banking was a perfectly sensible and natural evolutionary process. For just as individuals choose to place their deposits in banks, so banks place their own deposits in a safe bank and ultimately they find their way to the safest of all banks, the government's bank."

[22] K Dowd, 'Central Banking in England 1821-90' p. 163 in F Capie, Wood *et al*, *Unregulated Banking: Chaos or Order?* Basingstoke Macmillan (1990)

[23] Chapter 2, The Role of the Bank of England and The Financial Services Authority at p. 42

[24] House of Commons, Second Reading, *Bank of England Bill*, 29th October 1946 col. 52; see also Minutes of Proceedings of the Select Committee on the *Bank of England Bill*, Together with the Minutes of Evidence, HMSO, London 20th November 1945 at p. 10

[25] House of Commons, *Bank of England Bill*, 17th December 1945, According to Captain Crookshank, "...which is a great infringement of the liberty of action of a bank in a business sense." at para., 1003

[26] 1946 Act s. 4(3):

> "The Bank may, if they think it necessary in the public interest, request information from and make recommendations to bankers, and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any request or recommendation."

[27] Seventh Report, *Nationalised Industries* (1975-76) HMSO at p. xiv, para., 17

information.[28] It would be naive to think that moral persuasion did not experience some resistance and necessitate a formal request.

The Bank maintained a unique overview of the UK 'capital markets', building a working relationship with discount houses, clearing banks and merchant banks. A 'ladder of recognition', existed, based on the reputation of the institution within the banking community.[29] A rather *ad hoc* definition of banking existed that provided reference to the term 'bank' and 'banking' with limited explanation as to what type of business it generally included. This approach was perpetuated by those responsible for authorising such institutions, the Treasury and the Bank.[30]

The definition of banking evolved from statutes which simply listed the type of business that was considered equivalent to banking. For example, 'Schedule 8' banks were exempted from specific disclosure rules and had the right to have hidden reserves. The Exchange Control Act 1947 (1947 Act) simply referred to banks authorised to undertake foreign exchange business. However, the 1947 Act, required the Treasury and the Bank to establish a list of authorised banks. Authorisation under the 1947 Act was based on the Bank's judgement of whether the institution was deemed acceptable to both itself and the banking community as a bank in the 'full sense'.[31] Another form of recognition was listing for the purpose of s.127 of the Companies Act 1967 this exempted banks from the advertisement rules under the Protection of Depositors Act 1967. Finally, at the bottom of the 'ladder' were s. 123 banks registered under the Companies Act 1967.

The s. 123 banks' experienced the brunt of the secondary banking disaster. This disaster required support from the Bank as 'Lender of Last Resort' to avert a systemic collapse within the UK capital markets.[32] The systems of recognition before

[28] Select Committee on the *Bank of England Bill* (1945) at p. 16, para., 59-61

[29] Ibid., at p. 5-24; Bank of England, 'Supervision of Banks and other Deposit-taking institutions', *Bank of England Quarterly Bulletin*, June (1978) 383-386

[31] For a broad analysis of how the Bank judged a bank's reputation and standing see, Bank of England, 'The Supervision of the UK Banking System', *Bank of England Quarterly Bulletin*, April (1975), 188-194

[32] Bank of England, 'The Secondary Banking Crisis and the Bank of England's Support Operations', *Bank of England Quarterly Bulletin*, April (1978), 230-236; for a comprehensive examination see, M Ried, *The Secondary Banking Crisis 1973-75*, Basingstoke, Macmillan (1982)

the secondary banking crisis lacked any standardisation. The UK Government's response to the secondary banking crisis was to provide a system of authorisation of deposit-taking business because of the lack of uniform authorisation and inconsistent prudential supervision. Subsequently, prudential supervision, as we know it today, was not conducted until after the secondary banking crisis, and it only arose in an informal manner from 1975 for the statistical banks. Prudential Supervision was extended later to secondary banks who started to submit prudential returns to the Bank. However, for Landham, [33] s. 4(3) of the 1946 Act was sufficient to build a close relationship between the Bank and other institutions. Subsequently, the Bank could have thus regulated and supervised banks under s. 4(3) of the 1946 Act in the same way as it could under the 1979 Act. The large degree of discretion built into s. 4(3) of the 1946 Act allowed it to make recommendations and give directions. Therefore, the existence of s. 4(3) of the 1946 Act called into question the necessity of the 1979 Act.

### 1.4 The Banking Act 1979

The introduction of the 1979 Act codified and formalised banking regulation and supervision to ensure that institutions outside the purview of the old system were firmly within the control of the Bank.[34] This Act devised two distinct levels of 'authorisation': the first placed great emphasis on trust and co-operation with 'recognised institutions'; the second, to which 'licensed institutions' were subject provided for more intense measures of scrutiny.[35] The institution 'recognised' or 'licensed' as a bank was determined by the number of banking services it provided. Prudential controls were stricter for 'licensed institutions' than for 'recognised banks'. In many respects, the authorisation strategy of the 1979 Act was correct; it attempted to bring under the authority of the Bank institutions that lacked a relationship the 'recognised institutions' grew to accept.[36] The justification for this change was that

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[33] R H Landhman, 'A Need for New Legislation?', Vol. 17, No. 4, *Credit the Quarterly Review of the Finance House Association*, (1976), 78-87 at p. 80

[34] *The Licensing and Supervision of Deposit-Taking Institutions*, Cmnd 6584, HMSO, London (1976) at p. 3; F R Ryder, 'The Banking Act 1979', *Journal of Business Law*, (1980) 92-98 at p. 93

[35] 1979 Act s. 3 (3) (a) (b) Schedule 2 Part I Recognised Banks & II Licensed Institutions. For some the two tier system was to rigid and needed to be more flexible, see: Parliamentary Debates, House of Commons, Standing Committee A, *Banking Bill*, Third Sitting, Tuesday 12th December 1978 col. 117

[36] The Bank attempted to allay concerns about its new statutory powers, see: Bank of England, 'Banking Supervision and the Banking Act', *Bank of England Quarterly Bulletin*, June (1980) 205-208

the licensed institutions were new to the industry and required a formal framework of regulation to understand what prudential supervision amounted to in the industry.[37]

### 1.4.1 Johnson Matthey Bankers

The collapse of Johnson Matthey Bankers (JMB) disappointed the assumption that it was a recognised bank with a good reputation and position in the gold bullion market. JMB was a traditional bank known for its wholesale banking business, including gold bullion, foreign exchange dealing, trade finance and insurance business. The business involved professional counterparties rather than small depositors from the wider public. The collapse resulted from the exposure of two of its long-standing customers whose identity was not disclosed to the Bank.[38]

The incident highlights the difficulties of monitoring the actual business of a bank, that thin line upon which supervision attempts to safeguard the interests of depositors. The supervisory regime rightly assumed that recognised institutions would act in good faith and comply with the prudential requirements.[39] This was not to say that the 1979 Act did not provide appropriate sanctions against failure in compliance nor the means of revoking an institutions recognised status or license. The Bank declared that it was not an adjudicator but rather an administrator and so it would refrain from taking an investigative role in such matters. However, the Bank's rationale is questionable because the role of a regulator necessitates the making of decisions on whether an incident is an instance of non-compliance and whether it is sufficiently severe to attract sanctions.

The Bank considered JMB important because of its membership of the gold bullion market. Threat of a business's moving to other financial centres (bank closures in the US had seen such a consequence) was real in the event of support being withheld. The Bank justified its decision to rescue JMB partly in terms of its desire to avoid that risk, which would avert an undermining of confidence in the London markets and the risk of contagion by a run on its assets.[40] This incident

[37] Bank of England, 'Banking Supervision: Statutory Control or Self-Regulation', *Bank of England Quarterly Bulletin*, December (1975) 367-369
[38] Bank of England, Report and Accounts (1985) 34-42, at p. 34-35
[39] Ibid., at p. 36
[40] Ibid., at p. 38-39

brought to light some of the inadequacies of the 1979 Act.[41] The Leigh Pemberton Report made a number of recommendations to improve prudential supervision.[42] The recommendations highlighted the importance of maintaining the Bank's role as an administrative body. This approach would reduce the risk of capital loss to depositors from imprudent bank behaviour and fulfil the Bank's wider a role of maintaining the stability within the banking system.[43] Notwithstanding the broad policy aims, a number of practical measures were advocated to improve prudential supervision.

### 1.4.2 Banking Act 1987

The review of banking supervision in the UK resulted in the Banking Act 1987 (1987 Act). The 1987 Act did not overhaul the existing system of supervision but merely built on a system that had formalised a traditional approach to authorisation and supervision. The Bank was given a general duty to regulate the acceptance of deposits in order to protect the interests of depositors. The 1987 Act abolished the two-tier system of authorisation, putting in place a single system which would be applied to all institutions accepting deposits in the course of their business. Many were sceptical about the flexibility that 1987 Act provided, particularly about the large measure of discretion it allowed the Bank to exercise in the way it might carry out its responsibilities. [44] The changing nature of the banking business meant that legislation would have been out-moded.

#### 1.4.2.1 The Collapse of BCCI

The collapse of the Bank of Credit and Commerce International (BCCI) is considered to be one of the major banking frauds of the 20th Century. The closure of BCCI called into question the Bank's methods of prudential supervision of authorised institutions.[45] The cause of BCCI's closure in the UK was the discovery that widespread fraud and mismanagement had rendered it insolvent. The Price Waterhouse Report under s. 41 of the 1987 Act led to the discovery of the large scale

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[41] Bank of England, *Banking Act 1979 Proposals for Legislative Change, Consultation Paper by the Bank of England*, Banking Supervision Division, Bank of England, July (1985)

[42] *The Committee to Consider the System of Banking Supervision*, HMSO, London, Cmnd 9550, June (1985)

[43] *White Paper on Banking Supervision*, HMSO, London, Cmnd 9695, December (1985)

[44] Parliamentary Debates, House of Commons, Standing Committee E, *Banking Bill*, Third Sitting Thursday 18th December 1986. Mr Nelson MP, col. 79 and Ian Stewart MP, col. 80-81

[45] Inquiry into the Supervision of The Bank of Credit and Commerce International, The Right Honourable Lord Justice Bingham, HMSO, London (1992) (Bingham Report)

fraud and, based on the evidence, the decision to close BCCI was made by the Bank on the 5th July 1991. The BCCI collapse exposed a catalogue of failures and irregularities that were found to have existed before revocation took place. The evidence called into question whether the Bank acted early enough to reduce the damage caused by the collapse. The Bank contended that implementing restrictions on an authorised institution could result in a collapse in confidence causing a run on a bank's assets. Therefore, the decision to implement restrictions needed to be balanced against the interests of BCCI's depositors. The decision to close, therefore, only came when the Bank was given overwhelming evidence of fraud and misconduct. The Bank's official view regarding the BCCI closure was that there had been insufficient evidence to justify the closure until it received the report pursuant of s.41 report of the 1987 Act was received.[46] According to Mr Quinn, Deputy Governor:

> "*...restrictions would be visible and become known, because the restrictions would, in the ordinary course, amount to a prohibition on doing new lending or they could limit the amount of new deposits...which would become evident very quickly.*"[47]

The justification for such inaction is that not 'invoking rules' is a legitimate characteristic of the supervisory job.[48] The problem at BCCI, could have been remedied by the exercise of broader powers within the regulatory rules. A broad range of conditions and limits existed which were more sensitive than prohibiting new lending. For example, rectifying the problems within the governance of BCCI, which were at the root of the fraud.

BCCI managed the group in such a way that supervisory authorities found it difficult to understand the relationship between the various entities. For example, the holding company incorporated in Luxembourg was not regulated. BCCI also used its other 'sister company', International Credit and Commerce Company (Overseas) Ltd (ICIC), to manipulate its financial affairs. The concerns surrounding ICIC were made public when Price Waterhouse qualified its accounts in the face of large discrepancies in the concentration of business.[49] The evidence showed that a large amount of

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[46] Fourth Report from the Treasury and Civil Services Committee, Banking Supervision and BCCI: International and National Regulation, Session (1991-92) at p. xiv

[47] Ibid., at p. 47, para., 215

[48] Fourth Report Session (1991-92) op. cit., n. 46, at p. 47, para., 216

[49] Bingham Report (1992), op. cit., n. 45, at p. 64, para., 2. 126

deceptive practice took place in the group and some of it implicated senior management. This called into question whether they were 'fit and proper' for participation in the banking business. Records, BCCI management had responsibility for, were systematically falsified over a long time. The opacity of the group made it difficult for any one regulator to understand what was actually going on. Consequently, the 'College of Regulator' was set up, which included the Cayman Islands, France, Hong Kong, Luxembourg, Switzerland, United Arab Emirates and the UK. [50]

BCCI had failed to comply with prudential controls: It failed to comply with large exposure guidelines and connected lending provisions, especially to its Middle Eastern clients who were also shareholders. In the 31st of December accounts 1990 Price Waterhouse informed the Bank that large discrepancies had been found in the accounts totalling $600 million in unreported liabilities. The BCCI group had consistently made large losses over the 1980s. This led to the conclusion by Price Waterhouse that in its business dealings BCCI had systematically breached virtually all of the principles to which schedule 3 of the 1987 Act amounted. On 19th July the UK authorities announced an Inquiry by Lord Justice Bingham (as he then was) into the collapse of BCCI:

> "*To enquire into the supervision of BCCI under the Banking Act; to consider whether the action taken by all the UK authorities was appropriate and timely; and to make recommendations.*"[51]

Bingham LJ did not undermine the existing regime of banking supervision. Nevertheless, His Lordship did make a number of recommendations to the Bank, to change the way it administrated supervision. For example, His Lordship suggested that the Bank improve the inquisitiveness of its supervisory staff.[52] The Report also recommended the setting up of a 'Special Investigations Unit' and the revamping of

[50] Fourth Report, Session (1991-92), op. cit., 46, at p. ix

[51] The inquiry required five factors to be considered:

1. "What did the United Kingdom authorities know about BCCI at all relevant times?
2. Should they know more?
3. What action did the United Kingdom authorities take in relation to BCCI at all relevant times?
4. Should they have acted differently?
5. What should be done to prevent, or minimise the risk of, such an event recurring in the future?" Bingham Report (1992) op. cit., n. 45, at p. iii

[52] Bingham Report (1992) op. cit., n. 45, at p. 182, para., 3.9

the 'Legal Unit', this included the use of trained specialists for examining banks and for enhancing investigatory roles. The core criticism was directed at the use of supervisory powers and did not pinpoint actual defects of those powers. The timing of BCCI's closure and the uncertainty surrounding the grounds for revocation raised a number of concerns.

The Report suggests that market intelligence should have been used in regulatory decision-making. It required the Board of Banking Supervision (the Board) to act as a surveillance body for the Bank collecting rumours and market gossip that would, in normal circumstances, not warrant investigation. The exception occurs where the information is accumulated over time and seems to warrant an investigation. Subsequently the Board were required to be alert 'to any fact which *might* cause their attennae to twitch.'[53]

**1.4.2.2 The Collapse of Barings Bank**

The demise of Barings brought to the fore the concern surrounding bank securities trading. Nick Leeson's activities resulted in massive losses totalling £827m, causing its parent company Barings Bros. & Co to be placed in the hands of administrators. The Dutch bank ING bought Barings for a nominal sum of £1. The collapse was a surprise because it was one of the most established merchant banks in the City of London with a history spanning two hundred years. The demise of Barings Bros. & Co was caused by Nicholas Leeson's illegal trading activities at Barings Futures (Singapore) Pte Ltd (BFS), where he was head trader. Leeson was trading in futures and options on Singapore and Japanese Futures and Options Exchanges particularly on Simex and the Osaka Stock Exchange. The Barings collapse, calls into question the role of management, auditors and regulators, because it reveals that information about regulatory failures was available for detecting what Leeson was doing. In the light of this, a shared burden of responsibility exists for the collapse of Barings. The Bank declined the call to rescue Barings, to prevent moral hazard within the markets and because the size of the losses grew sharply over a very short period. A request was made by the Bank to the Board of Banking Supervision to conduct an

[53] Bingham Report (1992) op. cit., n. 45, at p. 182, para., 3.6

investigation into the huge losses at Barings.[54] The international nature of the Barings collapse also obliged Singapore to undertake its own investigation. While the UK Report does not implicate senior executives, the Singapore Report does suggest that senior management knew more than it disclosed.[55] The aim of the Bank of England Inquiry was:

> *"To establish in detail the events that led to the collapse of Barings; to identify the lessons to be drawn for institutions, for the Bank's own regulatory and supervisory arrangements, and for the UK system of regulation more generally; and to report to the Chancellor of the Exchequer."*[56]

The report found that Leeson was clearly acting beyond his responsibilities, for example, he exceeded his intra-day trading limits and had acted without authority by trading in options for his own account. The trades were then concealed by placing the losses in the famous "88888" account. The catalyst for these huge losses was Leeson who undertook responsibility, surprisingly for both the front office trading and back office settlement of accounts. Senior management did not effectively control or monitor Leeson's activities. This lack of oversight reduced the likelihood of detecting his unauthorised trading.[57] The UK Report pointed to systematic failures by management to know what business Leeson was conducting. Barings bank lacked the basic internal controls to assess the financial instruments within which he was taking positions. The lack of segregation between client funds and house transactions resulted in continuing losses. The inquiry identified a number of warning signs which were not acted upon either by the management of Barings or by the Bank: the segregation of duties; the unusually high level of profits from perceived low risk activities; the SLK receivable; funding of margin calls; the confusion over the large exposure returns relating to margin payments. The informal concession given to Barings effectively made BLS a branch of Barings Bros. & Co that provided a gateway to fund BFS.

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[54] The Board of Banking Supervision had the assistance of the Special Investigatory Unit of the Bank and independent members of the Board to conduct the investigation into the supervision of Barings.

[55] Barings Futures (Singapore) Pte ltd Investigation pursuant to section 231 of the Companies Act (Chapter 50) *The Report of the Inspectors appointed by the Minister for Finance*, M L C San and N T N Kuang Partners of Price Waterhouse, 6th September (1995)

[56] *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings*, HMSO, London issued 18th July (1995), at ch. 1., para., 1.2 (Barings Report)

[57] Ibid., at para., 13-81

While Barings' collapse did not bring about legislative change, it did produce an extensive reassessment of banking supervision. A proportion of the recommendations focused on management responsibilities such as: the importance of effective internal controls and systems; and of ensuring that management understand the business risks it faces. Recommendations were also directed to Bank: For the purpose of 'solo and consolidated' supervision it needed to understand how non-bank activities could impact on authorised institutions.

The reassessment of banking supervision included a review by Arthur Andersen of the Bank's Supervision and Surveillance.[58] The focus of the review was the 'appropriateness and effectiveness' of Supervision and Surveillance and on devising recommendations for the establishment of a Quality Assurance function. The Review did not recommend an overhaul of banking supervision. On the contrary, it advised that the existing style of supervision should be retained. However, clearer standards and objectives were considered necessary to clarify the Bank's approach to supervising deposit-taking institutions. This was to include: implementing a more systematic approach to supervising institutions; enhance the experience of existing staff; and specialist knowledge within the division. Finally, the Review also recommended the use of a risk-based approach to supplement Schedule 3 of the 1987 Act. The risk-based approach would introduce a formal 'supervisory period' and the performance of a 'risk assessment review'.[59]

### 1.5 The Securities Industry

The competitiveness of the UK securities markets came under significant pressure with the deregulation of the New York Stock Exchange. This was a catalyst for the UK to enhance the international profile of the London Stock Exchange[60] The pressure for change also existed domestically with the threat of legal action by the

[58] Arthur Andersen & Co, SC, *Findings and Recommendations of the Review of Supervision and Surveillance*, Arthur Andersen Consulting, London July (1996) (Arthur Andersen Report)
[59] Ibid., at para., 44
[60] For background see, D E Ayling, *The Internationalisation of Stockmarkets: The Trend towards Greater Foreign Borrowing and Investment*, London Gower Studies in Finance and Investment 1, 1986; J B M Hall, 'Reform of The London Stock Exchange: The Prudential Issues', *Banca Nazionale del Lavoro*, (1986), 167-181; J Plender, 'London's Big Bang in International Context', *International* Affairs, (1987) 39-48; N G Terry, 'The 'Big Bang' at The London Sock Exchange', April, (1985) 16-30; G P Gilligan, 'The Origins of UK Financial Services Regulation', Vol. 18, No. 6, *Company Lawyer*, (1997), 167-176

Office of Fair Trading. The potential action was targeted at the Exchange's fixed commission policy and membership scheme. The potential legal proceedings brought into question the 'single capacity' system of buying and selling securities. The new initiative proposed a 'dual capacity' system which would enable institutions to function as market-maker and broker. The change was vehemently opposed by the Exchange. However, pressure by the Bank led to an agreement between the Stock Exchange and the Government to phase out minimum commissions.[61] The 1980s also saw a further catalyst for regulatory change, the loss incurred by S G Warburg and other investment management companies. These failures prompted a review of the whole industry by Professor L C B Gower. His findings were incorporated in the Financial Services Act 1986 (1986 Act).

The role of the Bank is traditionally analysed in terms of banking regulation and supervision. However, the Bank also exercised significant influence over the securities industry. [62] Therefore, it became the voice of the 'City of London' ensuring that the 'status quo' in terms of regulation was maintained.[63] The Secretary of State set up the joint review body, which included the Department of Trade and the Bank, to co-ordinate a response to the developments in the securities industry during the 1970s.[64] The Joint Review Body, consisting of the interested parties who were perceived to be the expert parties took an evolutionary approach. Its review recommended the establishment of the Council for the Securities Industry (CSI) with the support of the Bank, and the Take-over and Mergers Panel.[65] The Bank, in its statement on the CSI, underlined the approach to be adopted:

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[61] Bank of England, 'The Future of the Securities Market', *Bank of England Quarterly Bulletin*, June 1984, 189-194, at p. 189; Bank of England, 'The City Revolution', *Bank of England Quarterly Bulletin*, September 1985, 422-427, at p. 423

[62] B Rider and E Hew, 'The Regulation of Corporation and Securities Laws in Britain-The Beginning of the Real Debate', Vol. 19, *Malaya Law Review*, (1977) 144-174 at pp. 155

[63] In the mid-1970s this was deemed an illusion, see: Seventh Report from the Select Committee on Nationalised Industries Session (1975-76) The Bank of England, London HMSO at p. xliv-xlv, para., 94-98

[64] B Rider and E Hew, 'The Structure of Regulation and Supervision in the Field of Corporation and Securities Laws in Britain', *Revue De La Banque*, (1977) 83-107 at p.105

[65] B Rider, 'The British Council for the Securities Industry', *Revue De La Banque*, (1978) 303-320; B Rider and E Hew, 'The Role of the City Panel on Take-Overs and Mergers in the Regulation of Insider Treading in Britain', Vol. 20, *Malaya Law Review* 315-343; B Rider, 'Self Regulation: The British Approach to Policing Conduct in the Securities Business, with particular reference to the Role of the City Panel on Take-Overs and Mergers in the Regulation of Insider Trading', No. 3, Vol. 1, *Journal of Comparative Corporate Law and Securities Regulation*, (1979) 319-348

*"[T]he Council is a voluntary body consisting of persons, bodies or associations which have subscribed to the concept of self regulation".* [66]

This was considered the most appropriate method of dealing with a highly diversified industry. The constitution of the CSI was within the mould of pre-existing forms of control, so not surprisingly, the old problems persisted. Also, it left room for abuse by the association because it allowed a minimalist approach to regulation. The concern about regulatory capture by the associations was another threat to the integrity of the Council. The actual impact of the CSI was limited because it lacked the appropriate ingredients to effectively regulate the securities market: its role was ambiguous; it lacked the resources and support to operate effectively; and it was toothless as an enforcer.[67]

L C B Gower had the task of assessing investor protection for both private and business investors. [68] This was a huge task given the different levels of protection required to safeguard their interests. Prof. Gower was constrained by both the will of the 'City of London', to preserve the notion of 'self-regulation' and the Government's will to avoid the idea of a 'securities commission'. Gower's work was further undermined by the appointment in 1984 of an advisory group established by the Bank to re-emphasise the importance of self-regulation. This highlighted the persistence of the tradition that the Bank was inclined to preserve the 'club-like' atmosphere.[69] A key difference introduced by the Government White Paper was in the move from

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[66] Ibid., B Rider, (1978), at pp. 306. Its responsibilities are:
(a) To maintain the highest ethical standards in the conduct of business within the securities industry.
(b) To keep under constant review the evolution of the securities industry, market practice and related Codes of Conduct ant to scrutinise the effectiveness of existing forms of regulation and the machinery for their administration.
(c) To maintain arrangements for the investigation of cases of alleged misconduct within the securities industry and breaches of codes of conduct or best practice and to keep these arrangements under review.
(d) To initiate new policies and codes as necessary concerning activities in the securities industry other than those properly within the domestic province of each individual constituent member.
(e) To resolve differences on matters of principle between constituent parts of the securities industry.
(f) To ensure liaison with the European Commission on securities industry matters and the implementation of EEC Capital Markets Code of Conduct.
(g) To consider the need for changes in legislation affecting the activities of the securities industry and to examine any proposals for such legislation.
[67] See B Rider and C Abrams, *Guide to the Financial Services Act 1986*, Bicester CCH Editions (1997) at p. 13
[68] L C B Gower, *Review of Investor Protection*, Cmnd 9125, London, HMSO (1984)
[69] Bank of England, 'Regulation in Financial Markets', *Bank of England Quarterly Bulletin*, December 1983, 499-501, at p. 500; L C B Gower, "Big Bang' and City Regulation', Vol. 51, No. 1, *Modern Law Review*, (1988) 1-22 at p. 10

'investor protection' towards 'efficiency' as the key driving force that ensures consumer confidence in financial markets.[70] This changed the emphasis of Gower's perception of regulation, to preservation of practitioner-based regulation on the assumption that the industry could regulate itself. This was eventually marketed as 'self-regulation within a statutory framework'.

The body given overall control of the new regime, under the Financial Services Act 1986, was the Securities and Investments Board (SIB).[71] The responsibility for appointing and removing the chairman and other members of the SIB was with the Secretary of State (Economic Secretary) and the Governor of the Bank of England.[72] This power vested in the Governor of the Bank highlights the importance of ensuring that the people appointed to run the SIB understood the culture of regulation and supervision required by the 'City of London'. The parties on the Board of the SIB were then not only politically acceptable but also acceptable to the industry. Concern for the overall cohesion of regulator and industry can be seen with the appointment of Sir David Walker (a non-executive director of the Bank of England) to replace Sir Kenneth Berrill; a lawyer by profession replaced with an economist. The new appointment recommended by the Bank ensured that the regulatory regime of the SIB would complement the approach considered acceptable to the 'City'. According to Rider:

> "*...he strove to project the SIB as being sensitive to the legitimate concerns if not the aspirations of the City*".[73]

SIB had the responsibility of ensuring that the designated 'Self Regulatory Organisations' (SRO), 'Recognised Professional Bodies' (RPB), and 'Recognised Investment Exchanges' (RIE) performed their delegated powers over their respective forms of investment business in accordance with the principles designated by the SIB. The initial five SROs were whittled down to three: the Personal Investment Authority

[70] DTI, *Financial Services in The United Kingdom: A New Framework for Investor Protection*, London HMSO, Cmnd 9432, January 1985 at p. 6
[71] Department of Trade and Industry, *Possible Changes to the Financial Services Act 1986*, DTI, London 1st March 1989; Financial Services Act 1986 (Delegation) Order 1987 (SI 1987/942), which transferred powers under s. 114(1) of the Financial Services Act 1986 to the SIB set out in sch., 7 of the FSA 1986
[72] Ibid., sch., 7, para., 1(2)
[73] B Rider, (1997) op. cit., n. 67, at p. 60

(PIA), the Investment Management Regulatory Organisation (IMRO) and the Securities Futures Authority (SFA). This reduction in the number of SROs was the result of concerns raised, in the wake of several SRO failures, about their effectiveness. The latter period of the SROs, existence witnessed the Maxwell affair and the pension mis-selling scandal that exposed limitations at IMRO.[74] In the former debacle a review of financial services regulation was conducted by Andrew Large.[75] A number of concerns were raised about financial services regulation, in particular the lack of clear objective for the financial services industry and a suspicion of regulatory capture.[76]

The growing recognition of the SROs and their regulatory responsibilities led to the notion that 'membership' was more of a hindrance than a positive attribute. The three remaining SROs introduced an authorisation process for institutions and individuals. In many respects, this emanates from a desire by the SROs to move away from the traditional idea of 'self-regulation', which had spawned negative connotations of regulatory capture instead of producing an efficient way of allowing practitioners to ensure that regulation worked effectively. According to the Treasury and Civil Service Committee Report (Report), the SROs attempted to project themselves as effective regulators rather than self-regulatory organisations serving members' interests. The Report deemed the notion of self-regulation a 'misnomer'.[77] Nevertheless, the pension mis-selling scandal tarnished the reputation of the current regime to the extent that a re-examination of the financial services industry was warranted particularly in view of the excess of time taken to settle the claims of victims.

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[74] R Hudson, K Keasey and K Littler, 'Retail Financial Services Regulation Snce the Financial Services Act 1986', Vol. 3, No. 2, *The Review of Policy Issues*, (1997) 23-35 *cf* with J M Hinchcliffe, 'The Manifest Failure of the Financial Services Act: A Comment on Hudson, Keasey and Littler', Vo. 3, No. 2, *The Review of Policy Issues* (1997 ) 37-48; reply R Hudson, K Keasey and Kevin Little, 'The Manifest Failure of the Financial Services Act: A Reply to Hinchcliffe', Vol. 3, No. 2, *The Review of Policy Issues*, 49-53. For focus on consumer protection, see generally D T Llewellyn, 'Reflections in Recent UK Experience of Financial Regulation', September, *Butterworths Journal of International Banking and Financial Law*, (1993), 375-381 at p. 375

[75] A Large, *Financial Services Regulation: Making a Two Tier System Work*, Securities Investment Board, London (1993)

[76] Ibid., at p. 8

[77] Sixth Report from The Treasury and Civil Service Committee, *The Regulation of Financial Services In the UK*, HMSO, London 23rd October 1995

## 1.6 Wholesale Money Markets

The wholesale sector consists of a diverse range of professional investors. The pressure to preserve practitioner autonomy as a mechanism of 'command and control' is very prevalent in these markets. The regulation of the wholesale money markets has a long history centred on the relationship between the Bank and trade associations.[78] The distinct codes-of-conduct of trade associations were the main vehicle of regulation. The Bank required the trade association to monitor compliance with those codes and their effectiveness to maintain 'high standards of business practice'.[79] The role of the Association in implementing codes of conduct and the Bank's role of maintaining good market practices worked and ensured that these markets grew: the Euro-currency market, the central driving force in the growth of the City, experienced little supervisory intervention.[80] The justification for this style of regulation in the Euro-currency market was that the market dealt with institutional positions. The Bank, as supervisor, was content to think that risks are taken in this market with an element of prudence.[81] The Bank's relationship with the market was such that no change was anticipated in its basis of supervision.

The style of regulation adopted by the Bank was preserved and legitimated with the introduction of the Financial Services Act 1986. The brokers and market makers in the wholesale markets were exempted from the business conduct rules governing the unsophisticated investor and retail industry. The Bank continued to be responsible for the wholesale money markets under s. 43 of the 1986 Act. The listed money market institutions were not solely banks but also large investment houses, building societies and local authorities.[82] These institutions were required to abide by the London Code of Conduct commonly referred to as the 'Grey Paper'. The 'Grey

[78] Wholesale transactions were in the region of £100,000-£500,000, see Bank of England, 'Supervision of the Wholesale Money Markets', *Bank of England Quarterly Bulletin*, February (1988); A Newton, 'The Bank of England's Revised Code of Conduct', Vol. 2, No. 2, *Derivatives Use, Trading & Regulation*, 158-162, at p. 160

[79] Committee to Review the Functioning of Financial Institutions, Cmnd 7937 London, HMSO (1980) Appendices, at p. 508 and J Cooper, *The Management and Regulation of Banks* London, Macmillan (1984) at p. 132

[80] The Committee to Review the Function of Financial Institutions, (1980) *Written Answers By the Bank of England to Questions Not Covered at the Oral Session on 5th December 1978*, op. cit., n. 77, at p. 167-169

[81] Bank of England, 'Supervision of the markets in money, foreign exchange, currency deposits and gold', *Bank of England Quarterly Bulletin*, June 1978, 379, at p. 387-389

[82] Bank of England, 'Change in The Stock Exchange and Regulation of the City', *Bank of England Quarterly Bulletin*, February 1987, 54-65, at p. 60

Paper', governed the way deals were executed in the wholesale money markets.[83] It promoted the idea that London is an efficient marketplace thriving on 'good market practice'. The Code is based on '*caveat emptor*' this is at variance to the traditional bank-customer relationship. An assumption exists in it that the parties understand the nature of the business and the transaction is at 'arms length'. This assumption was affirmed in principle by the decision of Mance J in Bankers Trust International.[84]

**1.7 Consensus Approach to Regulation and Supervision**

The regulatory approach adopted by the Financial Services Act 1986 and the Banking Act 1987, promoted competition and innovation by enabling cross-authorisation in other financial services.[85] Whilst both focused on safeguarding public interests, the key objective of the Acts and, the way they were implemented, promoted the pursuit of efficiency in the financial markets.[86] This approach to banking supervision recognised as fundamental the 'need to maintain and enhance London's competitiveness as an international financial centre'.

The blurring of demarcation lines between traditional forms of business required a co-ordination of activity across the jurisdictions of the SIB, SROs and the Bank. The Bank needed to understand how the latter institutions worked prudentially and how they could affect banking institutions.[87] Through its role of Lead Regulator it was able to share regulatory responsibilities between itself and the SIB.[88] The overlap in terms of regulating 'mixed business activities' warranted a co-ordinated approach such that supervisory activities would oversee bank-financial conglomerates and thereby reduce duplication of prudential supervision.

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[83] The BCCI saga, led to a revision of the Grey Paper, see: Second Report from The Treasury and Civil Service Committee, Banking Supervision and BCCI: The Role of Local Authorities and Money Brokers, Session (1991-92) London, HMSO at p. xii

[84] *Bankers Trust International plc and PT Dharmala Sakti Sejahtera* High Court of Justice QBD 1994 Folio Nos. 2168 and 1396 1st December 1995 at p. 19

[85] Bank of England, 'UK Approach to Financial Regulation', *Bank of England Quarterly Bulletin*, March (1986), 48-50; Bank of England, 'The Business of Financial Supervision', *Bank of England Quarterly Bulletin*, March (1984), 46-50; Bank of England, 'Change in The Stock Exchange and Regulation of the City', *Bank of England Quarterly Bulletin*, February (1987), 54-65 at p. 58

[86] Bank of England, 'Supervision and Competitive Conditions', *Bank of England Quarterly Bulletin*, June (1986), 242-244, at p. 243

[87] This is notwithstanding the fact that prudential supervision did evolve to cope with new forms of risk, see: Bank of England, 'Banking Risks in an Evolving Market', *Bank of England Quarterly Bulletin*, June (1985), 217-218; Bank of England, 'Some Current Concerns of a Banking Supervisor', *Bank of England Quarterly Bulletin*, (1990) 219-223

### 1.7.1 The Growth of Financial Conglomerates

Financial Institutions in the UK developed significantly during the 1960s and 1970s; these periods saw the initial dismantlement of specialisation which distinguished the various markets and their participants.[89] Other policy objectives played a notable part in moulding the present financial system, in particular micro-economic policies encouraging competition and regional integration.[90] These policies promoted the dismantlement of barriers between the segments of the financial sectors that had traditionally been the exclusive province of specialised institutions. De-regulation blurred the distinction between previously discrete business activities and forged their synergy. The Tripartite Group of regulators define a financial conglomerate as:

> *"any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)".*[91]

This definition reinforces the traditional idea of conglomeration, i.e. the merger of separate and diverse firms.[92] On a practical level this definition was qualified: a mixed conglomerate is a group of companies that is pre-dominantly commercial and/or industrial and consists a financial services unit.[93] The OECD broadened the definition with its suggestion that a financial conglomerate can be a firm which jointly markets different financial products:

> *"[T]he 1980's have considerably narrowed earlier differences and have fundamentally changed the perception of the overall competitive situation in the industry: various financial services have become to a large extent close*

[88] Bank of England, 'The Co-ordination of Regulation', *Bank of England Quarterly Bulletin*, August (1988), 364-366 at p. 365

[89] See generally, J Maycock, *Financial Conglomerates: The New Phenomenon*, London Gower Studies in Finance and Investment 2, (1986); A W Mullineux, *UK Banking After Deregulation*, London Croom Helm (1986) at p. 30

[90] OECD, *Banks Under Stress*, OECD, Paris (1992) at p. 15; OECD, *Competition in Banking*, OECD, Paris (1989) at p. 9

[91] A Report by The Tripartite Group of Bank, Securities and Insurance, *The Supervision of Financial Conglomerates*, Basle Committee, Basle July 1995 at p. 1

[92] The typical examination of conglomeration has centred round the fusion of bank and securities business. This is because the two types of business essentially relate to the redistribution and marketability of capital risk. In the case of banking supervision concerns have centred round the threat of bank runs. See, R Dale, *Risk and Regulation in Global Securities Markets*, Chichester John Wiley & Sons (1996) at p. 13. For an examination of securities business and systemic risk see: OECD, *Systemic Risks in Securities Markets*, OECD, Paris (1991) at p. 14

[93] K Koguchi, *Financial Conglomerates*, OECD, Paris (1995) at p. 35

*substitutes for each other and as a result, financial institutions operating primarily in theory "natural" market segments have become exposed to new forms of competition from different types of institutions.*"[94]

The effect of abolishing exchange controls in 1979 and the impact of the Big Bang in 1986 finally placed banks in a position where they could provide a wide range in securities business along side their banking and non-financial businesses meeting the needs of customers both domestically and internationally. The impact of this last but major dismantlement of traditional barriers of entry is put succinctly by L C B Gower:

"*Originally a stockbroker was just a broker of stocks and shares, an insurance broker a broker of insurance policies, a commodity broker a broker of commodities, a bank a provider of banking services, and a unit trust manager a manager of unit trusts. And by and large, each stuck to his lot. Today all these roles, and others, may, and often will, be undertaken by the same firm or group. And groups offering a full range of services are tending to become multinational.*"[95]

Having already established merchant banking arms, and later finance houses in the late 1950s clearing banks also pursued business in the growing wholesale and euro-currency markets. This is in stark contrast with the policy of prohibiting clearing banks from directly participating in such financial markets.[96] The dismantling of barriers provided the opportunity for clearing banks to participate in a wider range of financial services to build upon their retail and corporate banking business to ensure their ability to meet business needs of corporate clients. A number of foreign banks participated in the wholesale money markets (treasury and foreign exchange business). Competition for international corporate clientele intensified pressure in the UK banking industry, especially on the clearing banks, to enter this market and support its client base. Domestic banking operations remain the largest part of their business in terms of size, income and profits.[97] Competition in the retail market

[94] Ibid., at p. 13-14

[95] B Rider and M Ashe, *The Fiduary, insider and the conflict: a compendium of essays*, Dublin, Sweet and Maxwell (1995) at p. 89

[96] J Maycock, (1986) op. cit., n. 89, at p. 13

[97] Bank of England, 'International Banking in London, 1975-85', *Bank of England Quarterly Bulletin*, September (1986), 367-378; Bank of England, 'Developments in International Capital and Banking Markets in 1987', *Bank of England Quarterly Bulletin*, May (1988), 209-219

intensified with the growing number of Building Societies and foreign banks in pursuit of retail deposit-business.[98]

The deregulatory efforts of the 1970s and 1980s provided the catalyst for an even greater level of diversification. The push towards diversification resulted from the fear of loss in profitability and market share in the core areas. Whilst the OECD report suggests little evidence of efficiency gains from 'economies of scale' and 'synergies', it does highlight the long-term benefits to consumers. In terms of the wide 'availability of products' and better 'competitive prices'.[99] This has resulted in participation in various forms of business which can be easily integrated within a core portfolio of activities and distributed throughout branch networks.

Traditionally retail banking consisted of deposit-taking business at branch level. However, with the developments of technology and innovation banks have moved from a customer-branch relationship to a situation in which the needs of customers are met by Cheque Services, Card Services (such as credit cards and travellers cheques), Automated Teller Machines (ATMs), Telephone Banking, and Internet Banking. All these services have simply developed from the core service of 'accepting deposits'.

Mortgages, once the preserve of the Building Societies, experienced intense competition from the major UK banks when they entered this market in the 1980s. The underlying reason for this was that benefits accrued from the provision of a wide range of financial services (mortgages/consumer finance) and provided the possibility of cross selling to an existing client base. Whilst most UK major banks undertook this business within the existing arrangements, the market remained dominated by the old Building Societies (which have now converted to bank status), such as the Halifax. Lloyds Bank not only established its own estate agency business (Black Horse Agencies Ltd) but also, in 1996, acquired Cheltenham and Gloucester, a specialised

[98] A W Mullineux, (1987) op. cit., n. 89, at p. 96

[99] OECD Report (1995) op. cit., n. 93, at p. 70; See also D T Llewellyn, 'Banking in the 1990s: Challenges and Responses. Part 1', November, *Butterworths Journal of International Banking and Financial Law*, (1992), 528-534, at p. 529 highlights, "[t]he most efficient firms would become yet more efficient and the average efficiency of the industry would rise" this suggests that efficiency does not increase across the board and leads to 'monopolisation'.

mortgage provider to become the third largest residential mortgage lender as a group within the market.[100]

The high street banks have also begun to sell insurance and other financial products to their customers. These banks are commonly referred to as 'bancassurance' and they utilise the network of branches to distribute life assurance, pensions and general insurance products.[101] Whilst most of the retail bankers and financial institutions such as building societies provide insurance business, in some cases the traditional notion of banking ceases to exist. Lloyds' merger with TSB and earlier acquisition of Abbey Life, which is now a wholly owned subsidiary of Lloyds TSB, makes it the largest insurance provider amongst UK banking groups.[102] In terms of profits to the group, insurance and investment businesses are the largest contributors, exceeding the contribution from retail banking and mortgages.[103] Lloyds' interests in the insurance business seem to be never ending given its acquisition of Scottish Widows Fund and Life Assurance Society for £7 billion in 1999.[104] Whilst cultural differences in terms of sales approach exist between insurance and banking the banks' interests essentially remain in the distribution of such products. This does not alleviate the fact that risks from insurance business could affect the underlying banking business: the close relationship of banking and insurance within a group constitutes a risk element.

The wholesale and investment business side of the UK's major banks is regulated by the Financial Services Act 1986 and the SROs: IMRO and SFA. The major UK banks play a significant role in the wholesale and other forms of investment business. The business essentially involves wholesale banking for its own treasury (liquidity management) purposes or for its major clientele whether in the UK or abroad. Wholesale banking can involve foreign exchange dealing in the 'euro-

[100] Lloyds TSB Group, Annual Report and Accounts (1998) at p. 12 it is interesting note the fact that Lloyds as a group has not capitalised from the existing position when it acquired C&G in 1996, its market share remaining the same.
[101] A Sturdy, G Morgan and J P Daniel, 'National Management Styles: A Comparative Study of the Strategy of *Bancassurance* in Britain and France', in G Morgan and D Knights, *Regulation and Deregulation* (1997) op. cit., n. 8, at p. 154-177
[102] Lloyds TSB Group plc Annual Report and Accounts 1996
[103] Lloyds TSB (1998), op. cit., n. 100 at p. 16; which is the case across most banks that participate in insurance business, see: A Sturdy, G Morgan and J P Daniel, in G Morgan and D Knight (1997) op. cit., n. 8, at p. 158
[104] 'Wooing the widow', The Sunday Times, June 27th 1999 at p. 1

currency' market, money market instruments, OTC derivatives. The investment side may involve eurobonds, securities dealing and brokerage, fund management, securities custody services. A particular activity which has proliferated is the use of derivatives by banks for both own account and institutional clientele. UK banks have been able to capitalise on this type of business to an even greater extent with the internationalisation of these markets and establishing themselves abroad in order to be able to trade twenty four-hours-a-day in the major international centres: New York, London, Frankfurt and Japan.[105]

Most of the clearing banks acquired both jobbing and brokerage firms with the dismantlement of the monopoly of the London Stock Exchange. Barclays bank formed Barclays de Zeote Wedd (formerly de Zeote and Wedd Durlacher)[106] and National Westminster Bank formed County Natwest renamed Natwest Markets. However the 1990s and the intensity of competition took its toll on both institutions in terms of global equities business. Natwest had the added humiliation of large losses in its options business. Furthermore, its profits of £804 million in 1996 fell to £704 million in 1997. Both institutions sought solace from their core business areas and announced that they would be building upon them. In the case of Natwest, this meant a move from the equities business to consolidate its investment markets business into 'Global Debt Markets' and 'Global Corporate Advisory'. [107] Barclays bank restructured its investment business into 'Corporate Banking' and 'Barclays Global Investors' with its exit from the equities market.[108] The decisions by Natwest and Barclays are not unique. The major players in investment banking are acquiring or merging in order to safeguard their survival in the business. As are other areas of the financial service industry, investment banks are diversifying to avoid dependency on any one area. The need to do this is occasioned by the intense competition in the industry and by the fear of large losses that can so easily be incurred.[109]

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105 BIS, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity*, Bank for International Settlements, Basle (1996) at p. 21; see generally, BIS, *International Banking and Financial Developments*, Bank for International Settlements, Basle (1992) at p. 15; BIS, *International Banking and Financial Market Developments*, Bank for International Settlements, Basle (1995) at p. 8

106 Barclays Plc 1986 Report and Accounts at p. 18

107 Natwest Group Annual Report and Accounts 1997 at p. 7; see also M Blanden, 'Scythe to Success', April, *The Banker* (1997) 19

108 Barclays Plc Annual Report (1998) at p. 29

109 P Shearlock, 'Battle of the Bulge Bracket', March, *The Banker* (1997) 17-20

## 1.8 Conclusion

The Bank plays a major role in the style of regulation and supervision in the 'City of London', avoiding an over-regulating of markets by promoting the idea of efficiency and competition. This proved conducive to growth in the Eurocurrency market. Regulation of the financial services industry has evolved from distinct forms of regulation and supervision: The securities industry has tended to focus on financial regulation and conduct of business rules whereas deposit-taking business has focused on prudential supervision and given little heed to consumer protection. The lessons from Barings bank influenced securities regulation: Consolidated supervision was adopted because they recognised that their domestic focus had blurred their view of risks that are taken outside the UK.

While moral [per]suasion is not the central tenet of banking supervision it still remains a relevant backdrop in an analysis of regulation and supervision: It does underpin the forces that are operative in ensuring compliance with rules. The ad hoc system of authorising banking businesses lacked a formal cohesive system of controlling activities. Therefore, a single authorisation mechanism was clearly warranted and manifested in the Banking Act 1979 and the subsequent Banking Act 1987. During this period the Bank achieved a very commendable record in reducing the likelihood of bank failures. Notwithstanding this fact, the failures that did occur were spectacular: JMB, BCCI and Barings. These failures were not entirely attributable to systemic defect in the supervisory process. However, those failures did highlight the importance of regulators maintaining their vigilance and arraigning non-compliance with prudential controls. These failures showed evidence of: failure to observe large exposure guidelines, anomalies in consolidated supervision and that the appropriate level of trust was not forthcoming.

The regulatory climate surrounding banks has changed significantly, post-Barings when a major overhaul of prudential supervision was undertaken. While bank failures, and other financial failures have been significant highlighting the need for a 'single regulator', the greatest pressure for a single regulatory body has surely been the growth of financial conglomerates transcending distinct markets and financial products. The changes that began during the 1970s and continued through the 1990s have transformed the capital markets of London beyond recognition. Technological innovation has also played a significant role in these changes. Attendant upon these changes was an increase in the level of exposure to the common forms of risk, such as credit and market risk. According to the chief executive of Lloyds TSB these changes highlight the importance of transferring banking supervision to a single regulator, for such a regulator is one that reflects what is happening on the ground where most financial institutions are now selling banking and insurance'.[110] Having this capacity, the single regulator can also help purge regulations that lead-regulation has not been able to eradicate.

[110] 'One watchdog to monitor all City dealings' The Times, 21st May 1997

# Chapter 2

# The Roles of the Bank of England and The Financial Services Authority

## 2.1 Introduction

The role of the Bank of England (the Bank) has changed considerably in the last few years with the introduction of the Bank of England Act 1998 (1998 Act). This Act, transfers banking supervision to the Financial Services Authority (FSA), and changes the Bank's role in managing the Government's monetary policy. The transfer meant that the Bank lost its key role in the regulation and supervision of deposit-taking institutions and wholesale money markets. The Bank retains responsibility for monitoring financial stability, a crucial foundation of banking regulation and supervision.

In this Chapter, Section 1 provides a brief history of the Bank's responsibility for monetary policy. First it looks at the establishment of the Bank, together with its relationship with the Government, the Treasury and the FSA. Sections 2 and 3 focus on the impact of the Bank of England Act 1998 and the transfer of functions to the FSA. Section 4 considers the Bank's role a Lender of Last Resort (LOLR). The LOLR role is examined also in terms of the 'alleged globalisation' of financial markets and the systemic risks in securities markets. This will focus on the role of the Bank for International Settlement (BIS) and International Monetary Fund (IMF). Section 5 looks at the issue of ensuring stability and depositor confidence. This will require an examination of the use of Deposit Protection Schemes. Section 6 presents concluding remarks and considers the issue of moral hazard in the granting of support to financial markets. It will be established that banking regulation and supervision became necessary for avoiding instability in the economy. Section 7 considers the regulatory objectives formalised in the Financial Services and Markets Act 2000 (FSMA 2000). It will advance the claim that the FSA and FSMA 2000 were necessitated by the liberalisation of financial markets in the 1980s. Consequently, FSMA 2000 is essentially the process of re-regulating a de-regulated financial market. Section 8 draws the strands together and abstracts conclusions.

## 2.2 The Bank of England

The Bank (the 'Central Bank', as we know it today) has been operational in its present form since the 19th Century, functioning not only as the Government's bank but also as the exclusive note-issuer and lender of last resort.[1] However, the early period of its history also shows that the Bank functioned on behalf of the Government. The Bank of England was established in a period of economic and social distress. The country was at war with King Louis XIV of France and the Government was keen to raise money for the war effort. The most significant scheme for raising money was the proposal by William Paterson for the establishment of the Bank of England. The Bank of England was thus floated to raise a State loan of £1,200,000. Those who subscribed to the floatation were incorporated under the title of The Governor and Company of the Bank of England, giving the Bank the honour of a Body Corporate and granting it 'perpetual succession'. The Bank's Charter gave it the right to use a 'common seal' in all its business. Under the Charter the Governor and the Company of the Bank of England were an incorporated company with a discrete legal personality entitled to contract and deal as if it were an individual. The Bank Act 1697 extended the Bank's Charter by five years, and s. 61 reinforced its unique position as a corporation of national importance. This provided the Bank with an exclusive right of establishment and prohibited any organisation from functioning in a similar way.[2]

The importance of the Bank was further augmented by the Bank Act 1742, which introduced the idea of 'exclusive banking'. According to Richards, this was the first time the phrase 'exclusive banking' appeared in an English statute to recognise the Bank's monopolistic right to function with the Government and the Treasury.[3] The Charter required the Directors to grant the Government an 'advance' of £1,600,000. This price secured its unique position. The Bank Act 1708[4] re-affirmed

[1] W M Acres, *The Bank of England From Within: 1694-1900 Vol I & II*, London, Oxford University Press (1931); J Fforde, *The Bank of England and Public Policy 1941*-1958, Cambridge, Cambridge University Press (1992); J Clapham, *The Bank of England, A History 1694-1914*, (Vol. 1, 1694-1797 & Vol. 2, 1797-1914), Cambridge, Cambridge University Press (1944); R S Sayers, *Central Banking After Bagehot*, Oxford, Clarendon Press (1957); C R Whittlesley and J S G Wilson, *Essays in Money and Banking: In Honour of R S Sayers*, Oxford, Clarendon Press (1983)

[2] Ibid., Acres, Vol. I (1931) at p. 76

[3] R D Richards, *The First Fifty Years of The Bank of England (1694-1744)*, The Hague, Martinus Nijhoff (1934)

[4] Ibid., at p. 211

the Bank's unique position the joint-stock bank and prevented other banks from forming as joint-stock companies.[5]

The most significant change to the status of the Bank came about with the Bank of England Act 1946. This brought the Bank under public control and transferred the capital it held to the Treasury, effectively rendering it a nationalised institution. The idea of nationalisation was not new and had been advocated in mid-Victorian times.[6] The justification for nationalisation was clear: the Bank, acting as the central money reserve, served the key national interest of ensuring the well-being of the economy.[7] The Government formulated a standardised approach for all the industries that were nationalised. According to the Labour Party's election manifesto, the responsibilities of the Bank had to be brought under public ownership, and the operations of other banks had to be harmonised with economic needs.[8] This would ensure that the sectors of the economy were appropriately accountable.

### 2.2.1 The Relationship between the Bank and Government

The unique role of the Bank was not entirely granted by statute but evolved from its *de facto* function as manager of the national debt.[9] According to Sir Cyril Radcliffe, the relationship between the Government and the Bank was a close one. But the functions of the Bank were of a ministerial nature, and while its decisions were made on the non-legal basis of 'satisfactory chance', the possibility of conflict between the Bank and Government was actual.[10] Notwithstanding this fact, the promoters of the 1946 Act had no intention of breaking with the past in the matter of how the Bank executed monetary policy. Their intention was simply to formalise the relationship between the Government and the Bank by placing the Bank under the authority of the Treasury. The 1946 Act gave the Treasury broad discretionary rights

[5] Joint Stock Bank Act 1826

[6] The Select Committee on Nationalised Industries, *Seventh Report Part I* -The Historical Setting, London HMSO (1975) at para., 10

[7] Minutes of Proceedings of the Select Committee on *the Bank of England Bill*, Together with the Minutes of Evidence, 20th November 1945 at p. 7

[8] *Seventh Report*, (1975) op. cit., n. 6, at p. 1

[9] See generally: S Gray, *The Management of Government Debt*, Handbook in Central Banking No. 5, Bank of England, London (1996); Bank of England, "The Management of Money Day by Day", *Bank of England Quarterly Bulletin*, 15-19; Bank of England, "The Functions and Organisation of the Bank of England", *Bank of England Quarterly Bulletin*, 233-245; Bank of England, "The Bank of England: How the Pieces Fit Together", *Bank of England Quarterly Bulletin*, February (1996) 91-96

[10] Minutes of Proceedings, *Bank of England Bill* (1945) op. cit., n. 7, at p. 8

to give directions to the Bank in monetary matters that affect the public interest.[11] The opacity, that existed before the 1946 Act was perpetuated by the 1946 Act in that it failed to clarify the Bank's specific duties in implementing monetary operations.[12] The Bank had authority to provide other banks with direction and recommendation,[13] and it retained 'operational' independence from the Government in its daily management of interest rate and exchange rate policy. Its independence during this period was therefore very limited.

The Bank developed great expertise in monetary operations. On occasions, it disagreed with a government's policy recommendations and called into question the ability of a political body to make sound monetary policy when, by nature, it was weighted by ideological commitment. When such disputes arose over inflation policy, the Bank's position tended to be modified by a government intent on achieving short-term political objectives.[14] The former Prime Minister Margaret Thatcher, considered the possibility of establishing an independent central bank with responsibility for controlling inflation and interest rates as an admission of failure.[15] Even after the fall-out from the collapse of the ERM, the political concerns of the day outweighed support for the Bank's independence.[16] The resistance to independence was exposed by the monthly report on the meetings between Kenneth Clarke and Eddie George (popularly known as the 'Ken and Eddie show'). The quest for independence was supported by New Labour in Opposition, and implemented in its first term of office to side-step the traditional 'stop-go' procedure,[17] and to adopt in its stead a long-term approach to economic stability.[18]

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[11] Fforde, (1992) op. cit., n. 1, at p. 15

[12] Treasury and Civil Service Committee, *First Report*, *The Role of the Bank of England* Vol. 1, House Commons, Session 93-94, 8th December 1993

[13] See Chapter 1 Evolution of Banking Regulation and Financial Services Regulation at p. 10

[14] Treasury and Civil Service Committee, The Role of the Bank of England, Minutes of Evidence, Wednesday 12th May 1993, London, HMSO at p.1

[15] M Thatcher, *The Downing Street Years*, London, HarperCollins (1993) at p. 706

[16] *First Report*, (1993) op. cit., n 12, at p. x

[17] HM Treasury News Release, 'Chancellor Announces New Framework for Monetary Policy', 6th May 1997: http://www.hm-treasury.gov.uk/pub

[18] The move towards central bank independence is examined in F Giordano and S Persuad, *The Political Economy of Monetary Union*, London, Routledge (1998) at p. 62-76

**2.3 The Bank of England Act 1998**

The 1998 Act made significant changes to the role of the Bank. The Bank's relationship with the Treasury and the FSA is articulated in the Memorandum of Understanding.[19] This stipulates how the three organisations are expected to work together.[20] The Bank has the responsibility to monitor stability in the financial system. The idea of 'financial system' incorporates not only the banking sector but also those financial institutions in the wider commercial market that are potentially able to affect stability. The Bank was therefore required to monitor the infrastructure of the payments system, both domestically and abroad. This role was to play an essential part in assisting the FSA's regulation of financial institutions: It would be responsible for warning the FSA of possible problems in the domestic and international-payment systems that could affect the UK financial markets. The 1998 Act introduced a number of changes to the overall core purpose of the Bank.[21] Among other things, it bestowed upon the Bank the right of independent action in matters of interest-rate policy, and the relationship between it and the Treasury was re-configured.

The concept of 'independence', understood literally, entails the notion of 'unfettered authority'. The person in a position of unfettered authority enjoys self-governance and makes politically independent decisions.[22] It is interesting to ruminate on whether a person or an institution can occupy a position of independence, in a literal sense, in a context where a public body is exercising its mandate to act in the interest of the wider economic interest.[23] The parameters of the Bank's decision-making powers are defined by the 1998 Act and a number of objectives: maintaining price stability, supporting HM Government in its objectives of promoting economic growth and employment.[24] The Treasury, in its new role, is to provide the Bank with a written notice indicating what these objectives mean over twelve-month blocks of

[19] Bank of England, Banking Act Report, *Memorandum of Understanding between HM Treasury, The Bank of England and the FSA*, 1997/98, 37-39
[20] See 1998 Act Part III: Transfer of Supervisory Functions of the Bank to the Financial Services Authority
[21] The Bank of England, Report and Accounts (1998) at p. 15
[22] D Thompson, (ed.) *Oxford Compact, English Dictionary*, Oxford, Oxford University Press (1996) p. 504
[23] HM Treasury, News Release, (1997); see also T F Cargill, 'Can Central Bank Restructuring Solve Korea and Japan's Financial Problems?', *Central Banking* (1999) 44-57 at p. 49
[24] 1998 Act s. 11 (a) and (b). M Taylor, 'Flawed independence for the Bank of England Part I', *Central Banking*, (1997) 27-31

time.[25] This means that the Bank is required to manage short-term interest-rates to ensure that the Government's inflation target (currently 2½ %) is maintained across every twelve-month block.[26] Notwithstanding the operational independence of the Bank, the Government retains the authority to change the inflation target, which it can do annually or when it thinks it necessary.[27]

The Monetary Committee, under the 1998 Act, is responsible for the development and execution of decisions within set objectives, of the Government's monetary policy.[28] The advent of the Monetary Policy Committee was the Bank's key to independence, its freedom to 'de-politicise' decision-making. However, the process of appointing Committee members requires consultation with the Chancellor of the Exchequer.[29] This makes the appointment at least partially a political one. The integrity of the Bank's independence is further undermined by the fact that members' length of office (3 years) is statutorily stipulated (1998 Act). In other jurisdictions, the period of service is longer: fourteen years in the US to eight years in the German Bundesbank. Longer stretches of service tend to reduce the likelihood of political influence in decision-making.

The 1998 Act provided the Bank with greater decision-making power, but it allowed the Treasury, a political body, to maintain its guiding role.[30] The Treasury lost the power to give direction to the Bank on monetary issues pursuant of the provision under s. 4(1) of the 1946 Act, but it retained significant reserve powers to direct the Bank in the 'public interest' and in 'exceptional economic circumstances'.[31] In such cases, the Treasury can direct the Bank in accordance with the decisions of Parliament. The power is there to exercise when a major catastrophe is imminent

[25] 1998 Act s. 12
[26] This is in stark contrast to the German Bundesbank which has total target independence with an objective of price stability included in its statute. House of Commons, Standing Committee D *Bank of England Bill*, 27th November 1997 Mr Davey, col., 123-124
[27] Standing Committee D, *Bank of England Bill*, cl., 124-126. The frequency with which the government can change its targets is also very high, not only on an annual basis, but when the government thinks its necessary, section 12(2)(b). For further examination of central bank independence with particular emphasis on inflation policy see: J K Martijn and H Samiei, *Central Bank Independence and the Conduct of Monetary Policy in the United Kingdom*, International Monetary Fund, Washington DC, December 1999
[28] 1998 Act s. 13
[29] Ibid., s. 13
[30] Ibid., Part II
[31] Ibid., s. 19

nationally or internationally and capable of affecting the UK economy. The Treasury's powers in such circumstances suggest that the Bank's decision-making powers are not, as one would expect, independent.

The Bank is given the power to obtain information pertinent to its duty to assemble banking statistics. This is a power similar to that conferred under s. 82 of the Banking Act 1987.[32] The Bank's powers, provided they are not conducted *ultra vires*, seem wide. Although reassurance was given that, such power does not entitle it to go on 'fishing expeditions'.[33] Its powers identify the link between monetary stability and banking supervision: through prudential information the Bank can identify changes in the economy and advise upon how they might affect banks prudentially.

### 2.3.1 The Transfer of Banking Supervision to the FSA

The changes that arose during the 1980s and 1990s with the growth of financial conglomerates have called into question the appropriateness of specialist regulators. In the UK, the initial step towards a single, unified regulatory body was the surprising transfer of banking supervision to the FSA, in accordance with s. 21 of the 1998 Act. Consequently, further responsibilities were transferred from the Bank to the FSA: the Banking Act 1987; Second Banking Directive; s. 43 of the Financial Services Act 1986; Investment Services Directive; and institutions listed for the purpose of the money markets.

Section 22, Schedule 4 of 1998 Act, amongst other things, transferred the personnel of the Supervision and Surveillance Division to the FSA. This ensured that the specialist skills required to supervise banks were securely placed under the wing of the FSA. The 1998 Act introduced the payment of fees to fund the FSA's various responsibilities. The FSA, under s. 24 of the 1998 Act, is required to be an independent regulator with the same immunity from suit as the Bank's in relation to

[32] Ibid., s. 17: According to s. 17(3) an "undertaking" is authorised institutions, European authorised institutions, building societies, other monetary financial institutions, institutions which provide credits secured on land, financial holding company, those which provide debt securities and agents which arrange debt securities.
[33] Standing Committee D Tuesday 2nd December 1997 Bank of England Bill clause 17 col., 229-238

the transferred functions.[34] This immunity is limited to tort of negligence and does not extend to action alleging bad faith (misfeasance in public office) or to judicial review.[35]

The importance of establishing a single regulatory body responsible for banking, securities and insurance business is legitimated on a number of grounds: economies of scale, efficiency in terms of regulatory resources, overlap or gaps in previous regulatory efforts. However, unification should not be viewed as a panacea for regulatory failure. It is essentially a reactive measure to failures in the market. The UK is not immune to failures in its banking and financial-services industry, as the Maxwell affair and the scandal over pension mis-selling have each attested.[36] A unified body is arguably no more likely to reduce failures than a single specialist body, because institutional failure normally stems from a breach of trust on the part of the regulated.[37] Many of these debacles threaten the interests of the consumer rather than financial stability. This suggests that political pressure to re-emphasise consumer protection over and above efficiency has the ancillary purpose of appeasing the public rather than the primary purpose of ensuring financial stability. Unification of banking, securities and insurance is not necessarily the norm but rather the exception in single-specialist agencies, or even dual-regulatory bodies (combining banking, securities or insurance business).[38] A general problem that may cause consternation in a single-regulatory body is the conflict that can arise from rival concerns inherent in a policy objective, such as financial stability in banking supervision and consumer protection. This is likely to happen with the transfer of banking to a body that is essentially a securities regulator focused on the deployment of business rules devised for the protection of the consumer. According to Abrams and Taylor, regulatory failures can be reduced only if fundamental tools for effective supervision exist.[39] Therefore, unless a regulator is envisaged as an entity that has clear objectives and principles and

[34] 1998 Act s. 25: inserts an immunity clause protecting the FSA from liability which, could arise from its functions, under: s. 43 of the Financial Services Act 1986; Regulation 26 of the Investment Services Regulation 1995; and s. 171 of the Companies Act 1989
[35] The question of immunity is extensively examined in Chapter 7, Accountability of Regulatory Decisions at p. 263
[36] See generally, Chapter 1 Evolution of Banking Regulation and Financial Services Regulation
[37] See Generally, Chapter 4 Corporate Governance and Banking Supervision
[38] Central Banking, *How Countries Supervise their Securities Markets, Banks and Insurers*, London Central Bank Publications, 1999
[39] R K Abrams and M W Taylor, *Issues in the Unification of Financial Sector Supervision*, Washington DC (Monetary and Exchange Affairs Department) International Monetary Fund (2000)

is able to span the whole area of prudential regulation and supervision, the call for a single regulator is questionable.

### 2.3.2 The Memorandum of Understanding

The 1998 Act or the Memorandum of Understanding (MoU) does not define the role of the Lender of Last Resort (LOLR) function, though it is a key function of central banking.[40] The LOLR function is considered to be the *raison d'être* of central banking and works in two specific ways to ensure confidence in the financial markets: The first way (which is no longer used as it was in the past) aims to even out the large flow of funds between the public and private sector, *via* the discount houses. The second function attempts to manage financial crisis, either on a single-bank level or for the banking system as a whole, to prevent systemic instability or a risk of contagion.

According to the MoU, the Bank, with its LOLR role, has the facility for ensuring stability to avert systemic damage to financial markets. Nevertheless, the separation of the roles of LOLR and banking supervision has caused concern in some quarters: Even though the Bank retains the power to obtain information for monetary purposes,[41] supervision is recognised to be an activity most capable of obtaining the understanding to avoid monetary instability. The MoU does not define 'systemic damage', which means that assessment of when instability has systemic implications is left to the concerted judgement of the three central bodies. The MoU has in effect reverted to Bagehot's original suggestion that the Bank should be the LOLR to the whole financial system:

> *"In exceptional circumstances there may be a need for an operation which goes beyond the Bank's routine activity in the money market to implement its interest rates objective. Such an operation is expected to happen rarely and would normally only be undertaken in the case of genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy."*[42]

[40] Bank of England Report and Accounts 1998: Core purpose No. 2 at p. 8

[41] 1998 Act s. 17; see specifically, C A E Goodhart, 'The Organisational Structure of Banking Supervision', Special Paper No. 127, Financial Markets Group, London School of Economics October 2000 at p. 41; R Lastra, 'Banking Regulation in the 1990s', Vol. 13, No. 2, *Journal of International Banking Law*, (1999) 45-49 at p. 45

The MoU sheds little light on when the LOLR should come into play, leaving its operation in an ambiguous state, possibly to prevent complacency in the market. In many respects, it preserves the informality of this role by avoiding a statutory codification of its functions. The Bank is required to co-operate closely with domestic and international financial supervisors to avoid systemic damage in the financial markets. The LOLR, as its name makes clear, is utilised only in the most exceptional circumstances, after consultation with the Treasury, and now with the Financial Services Authority. The inter-dependence of the three bodies has the purpose of ensuring financial stability through monetary management, political equilibrium, and the proper management of the financial intermediaries within the market. The key operational responsibilities of the Bank and FSA are split in terms of 'lead operator': In cases where the problem originates in the payment and settlement system, the Bank will be deemed 'lead operator'. In the event of problems originating in the FSA's domain, it will be deemed 'lead operator'. In both circumstances, the Bank will be the ultimate source of liquidity.[43]

### 2.4 The Bank of England: 'Lender of Last Resort' and 'Official Safety Net'

The central bank ensures financial stability and reduces the likelihood of bank-runs by providing a safety net.[44] This was traditionally its role as the LOLR, a discretionary support-facility to guard against financial risks to creditors (depositors and investors).[45] However, another form of safety mechanism has also evolved, based on 'rules' which focus on the interests of depositors who have lost their money. This is commonly referred to as the Deposit Insurance Scheme (DIS). Both play a supportive role in ensuring financial stability and overall confidence in the financial markets. The LOLR facility is normally exercised in a time of liquidity problems. The Deposit Protection Scheme is exercised when deposit-taking institutions are deemed insolvent. The problem of moral hazard arises with both forms of support. However, the extent of moral hazard does vary. It is asserted that the LOLR function raises

[42] MoU (1998) op. cit., n. 19, at p. 39, para., 11
[43] MoU (1998) op. cit., n. 19, at p. 39, para., 12
[44] D Diamond and P Dybig, 'Bank Runs, Deposit Insurance and Liquidity', Vol. 19, *Journal of Political Economy*, (1983) 401-419 at p. 417; the idea of bank run and maintaining confidence is lso accepted by the courts see, *Re Chancery plc* [1991] BCLC 712
[45] T M Humphrey and R Keleher, 'Lender of Last Resort: A Historical Perspective', Vol. 4, No. 1, *Cato* Journal, (1984) 275-317

greater concerns about moral hazard because of the arbitrary manner in which it can be utilised.

The idea for a central LOLR was first officially proposed by Francis Baring in 1797, although Bagehot is also given recognition for putting forward the notion of a formal system for maintaining stability.[46] The LOLR function is essentially exercised by the central bank in order to prevent temporary situations of illiquidity in banks. According to Bagehot, such support should only be provided on 'good banking securities' because bad business is only a small fraction of the whole.[47] Bagehot proposed a restrictive interpretation of LOLR. However, LOLR has been exercised liberally in some jurisdictions to prevent financial turmoil and 'bad' securities have been made 'good'. According to Goodhart, if an institution experienced liquidity problems it could adjust its liquidity mismatch through its access to the wholesale money markets. But that could only be done if the market thought the institution solvent.

The Bank's influence was *sui generis* because it was the rightful authority for enforcing obligations and agreements in the capital markets. The support it provided was never rendered as its legal obligation to the market.[48] Rather, it was a support incumbent upon it as a moral obligation, given that it was the central body for note issuance. Banks came to rely on the Bank as a central facilitator of finance and had to co-operate with it in order to survive. The support given to prevent failure was essentially short-term and at a penalty. In the Bank's early history, support came at a cost calculated on the level of the Bank Rate or the Official Rate, which was far higher than the Market Rate.[49] The role of LOLR was first exercised formally in the rescue of Baring Brothers and Company in 1890.[50] Barings was deemed insolvent but the Bank orchestrated a rescue package, with the support of Russia and France, to

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[46] W Bagehot, *Lombard Street: A Description of the Money Market*, (1873), New York, John Wiley & Sons Inc (1999)
[47] Ibid., W Bagehot, (1999) at p. 97
[48] According to Macleod, H.D., (1896) 'A History of Banking in Great Britain' in W G Summer, *A History of Banking in all the Leading Nations* Vol. II New York (1896) at p. 123
[49] See Above for more details regarding the 'Bank Rate' and 'Market Rate', Section Two, Functions of the Bank of England.
[50] J Clapham, Vol. II (1944) op. cit., n. 1, at p. 326

prevent a panic that could have led to instability not only in England but also internationally.[51]

Financial instability can arise from a number of movements in the macroeconomic environment, such as a collapse in prices, a sharp increase in interest rates, or a collapse of exchange rates. These can cause a downturn in the economy, leading to panic and/or crisis in the financial system. According to Goodhart, systemic instability exists when 'the failure of one institution within the financial system may endanger the solvency of other related institutions'.[52] Systemic risk is traditionally a concern peculiar to the banking industry. However, the growing securities industry, both domestically and internationally, is now also wary of it. This has called for co-operation among securities regulators in ways similar to the co-operation among banking regulators. This brings to the fore the importance of having an LOLR available to the whole of the financial market. The contemporary interdependence of financial markets is such that financial stability is no longer a domestic concern but an international issue. Maintaining international financial stability is just as crucial as domestic monetary stability/financial stability. It requires a concerted effort not only among central banks but also among them international bodies such as Bank for International Settlement and the International Monetary Fund. According to White,[53] central banks are investing more resources in the issue of financial stability than was the case twenty years ago.

Support operations have been exercised to safeguard the interests of depositors, as they were in 1971, during the secondary bank crisis.[54] This crisis had the potential of causing a systemic risk by putting into jeopardy the interests of other banks, particularly the clearing banks. They posed real problems to the stability of the recognised banking system. The growth of recognised secondary banks developed

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[51] The Bank before the Barings episode conducted support operations where it would arrange assistance, by itself and on occasion with the aid of other bank institutions to prevent the spread of a panic and thus potential collapse of other banks. See H D Macleod, (1896) *A History of Banking in Great Britain* in W G Summer, *A History of Banking in all the Leading Nations,* Vol. II (1896) New York, Augustus M. Kelley (reprinted) (1971) at p. 123
[52] C A E Goodhart, 'Some Regulatory Concerns', Special Paper No. 79, Financial Markets Group, London School of Economics, December 1995 at p. 16
[53] R White, 'Evolving International Financial Markets: Some Implications for Central Banks', Bank for International Settlements, Working Papers. No. 66, April (1999) at p. 17
[54] M Reid, *The Secondary Banking Crisis 1973-75*, London, Basingstoke Macmillan (1982)

outside the purview of the Bank's restrictive qualitative and quantitative credit controls, and monetary ratios. This led to the development of new forms of business, the parallel money markets.[55] A number of bank and non-bank institutions had access to the money markets, causing their significant expansion on the inter-company and inter-bank market, which gradually fused their activities with those of the fringe banks. The market provided secondary and fringe institutions with access to sources of finance to. The finance thus raised was channelled into sources outside the official areas of investment, such as property, rather than into export and shipping industries.

The UK experienced a contraction of lending in the property market from the participants in the wholesale market, with the result that a number of banks developed large liquidity problems that obliged the Bank to organise a rescue package, commonly called the Lifeboat Operation. The Bank set up a Control Committee with the clearing banks in order to manage the crisis, and alternative avenues were sought, where possible, to rescue the ailing institutions, particularly from their shareholders.[56] The support from the clearing banks was given reluctantly. In some cases, the Bank gave support to institutions which many thought were undeserving, such as Slater Walker Securities Limited, who suffered losses from speculative activities. Slater Walker, a diversified financial group, experienced problems in its banking and property arms, two of its key areas affected by the crisis. This culminated in support from the Lifeboat Operation, formed by the Bank to provide liquidity support only to banks experiencing crises:

> "*Both were part of sizeable groups with sensitive external ramifications. Foreign currency obligations of the non-banking companies of the Slater Walker group, for example, amounted to some £75 million equivalent, a significant part of which was publicly held. Additionally, the Group was responsible to a large number of investors and pensioners through the funds managed in its unit trusts and life assurance business.*"[57]

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[55] For an extensive overview of the UK Financial institutions and markets at that time, see J Revell, *The British Financial System* London and Basingstoke, Macmillan (1973); Bank of England, 'The Secondary Banking Crisis and the Bank of England's Support Operations', April, *Bank of England Quarterly Bulletin*, (1978) 230-236

[56] Ibid., Bank of England (1978) at p. 233

[57] The justification for the support can be highlighted by Evidence given to the Wilson Committee as background to the "lifeboat operation". The evidence relates to Slater Walker and Edward Bates & Sons. Ibid., Bank of England (1978) at p. 235

Justification for the support was the foreign-exchange exposure of Slater Walker's non-bank companies. The Bank attempted to safeguard confidence in the UK capital markets, particularly the foreign exchange and euro-currency markets, because of their international attractiveness. The UK capital markets were adversely affected also by financial failures in the overseas markets, such as that experienced by the Israel-British Bank of Tel Aviv, which resulted in the closure of its London subsidiary. Lloyds Bank International again affected the London capital markets through its losses from fraudulent activity in its foreign-exchange markets. This period saw great turmoil in other foreign-exchange markets and resulted in the closure of First National Bank and Bankhaus Herstatt, and saw Landesbank and Union Bank of Switzerland sustain huge foreign-exchange losses.[58]

The secondary banks provided various banking services but very little by way of deposit-banking, which was the preserve of the clearing banks.[59] The secondary banking-crisis affected not only depositors but also investors. A study conducted by Franks and Mayer[60] on the effective methods of regulating the business of investment-management indicated that a large number of investment-management businesses were affected by the fringe-banking crisis.[61] It is important to note that what was considered to be a banking crisis affected other parts of financial institutions. This crisis draws attention to the vulnerability of institutions in a financial group to risks incurred by problems that develop in their non-financial arms.[62] After this incident one can say that the fringe-banking crisis not only exposed imprudent banking practices but also highlighted the imprudence in the securities industry, even though the Franks and Mayer study does conclude that investors in the business of investment-management experienced little loss.[63]

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[58] Ibid., Bank of England (1978) at p. 235

[59] J Revell, (1973), op. cit., n. 55, at p. 239-240, indicates five key features of the secondary banks: "(1) It is wholesale banking, in which both deposits and loans are for large sums. (2) The bulk of both deposit and loans is fixed for a definite period - term deposits and terms loans. (3) The business is international in scope, around 80% of deposits and loans being foreign currencies and attributable to overseas residents. (4) The secondary banking system is highly competitive, and agreements about rates are, with very few exceptions, unknown. (5) The system operates with a structure of interest rates which is higher than that of the deposit banks, at least for deposits if not for advances."

[60] J Franks and C Mayer, *Risk, Regulation, and Investor Protection. The Case of Investment Management* Oxford, Oxford University Press (1989)

[61] Some of these institutions which also affected investment institutions were; Cedar Holding; J.H. Vavasseur; Jessel Securities; Keyser Ullman and Slater Walker.

[62] J Franks and C Mayer, (1989) op. cit., n. 60, at p. 71-132

[63] J Franks and C Mayer, (1989) op. cit., 60, at p. 73-74

### 2.4.1 Support to Individual Institutions

The question of whether support should be given needs to be approached cautiously by a central bank. The question of support must be weighed against the concern of producing moral hazard, which is an environment of imprudence and complacency. In some circumstances, bank failures may pose little systemic risk. The rationale for support is open to question because it can result in moral hazard.[64] A key criterion for giving support is the likelihood that the local problem of one bank will spread to cause problems for other banks and financial institutions: Financial support was given in 1991 when some banks experienced difficulties after the collapse of the property market. Central bankers tend to cultivate the policy of uncertainty surrounding the granting of support because a perception of uncertainty tends to reduce the likelihood of moral hazard.[65]

In a number of incidents, the Bank has refused to support failing institutions, such as Overend Gurney & Co 1866, even though it did provide support to the wider financial market.[66] In Overend Gurney's case, the perception was that it had pursued its business interests in a 'spirit of greed' and attempted to gain high profits by taking 'extreme risk'.[67] This was also the case in the collapse of City of Glasgow in 1878, which was the result of high levels of fraud. In the case of Bank of Credit and Commerce International (BCCI), support was refused on the grounds that its closure was due to large-scale fraud, and because losses by depositors were covered by the Deposit Protection Scheme under the Banking Act 1987. The collapse of Baring Brothers and Company in 1995, occasioned by its non-bank subsidiary in Singapore, resulted from the activities of a 'rogue trader' and was not considered to merit support.

However, the Bank did provide support to Johnson Matthey Bank [JMB] because of the concern about the likely impact of its failure on the gold bullion

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[64] C A E Goodhart, (1995) op. cit., n. 52, at p. 20

[65] R White, 'Discusses Promoting International Financial Stability: the Role of the BIS', No. 62, *Bank for International Settlement Review*, (1998) 1-21 at p. 17 http://www.bis.org

[66] The Bank averted a panic by advancing £4 million to creditors and other key banking institutions. The government promised the Bank a Bill of indemnity to cover the excess of the statutory limit, on condition that advances and discounts should be at a rate not less than 10 %. This rate eventually alleviated the panic, but the demand for investments did not change. See W M Acres, *The Bank of England*, op. cit., n. 1, at p. 531

[67] W M Acres (1931) op. cit., n. 1, cited at p. 546-547

market.[68] When support is given, the Bank closely monitors the beneficiary institutions, and in some cases, acquires the institution for a nominal sum. The support given to Johnson Matthey Bankers (Minories Finance Limited) was not gratuitous. Rather, it was given in order to ensure that the organisation can develop an ability to repay the indemnity. The £52.2 million support package given to Minories Finance Ltd included dividends from the settlement of the case against the former auditors, Arthur Young, and the recovery of part-provisions that enabled the Bank to pay member institutions of the London Bullion Market Association for their contribution to the support operation. The remainder of the dividends was used to reimburse the Bank for its contribution to the support operation.[69]

### 2.4.2 International Lender of Last Resort

Under the MoU the FSA is required to co-operate with other central banks to ensure financial stability in the international financial markets.[70] Whilst central bankers perform the role of LOLR within their domestic economies to avoid crises that damage market confidence. The internationalisation of financial markets created the problem of who should be responsible for deflecting financial crisis in the international arena.[71] The two main players in this role are the Bank for International Settlement (BIS) and the International Monetary Fund (IMF). These institutions both have functions comparable with those of a domestic LOLR.

The BIS was established in 1930 in order to facilitate payments between central banks and promote co-operation among central banks. BIS membership is limited to the major industrialised nations; only recently has it admitted some other countries. A central concern of the BIS has been the nurturing of international monetary and financial systems through times of crisis, especially by its management of external reserves. For example, the BIS co-ordinated central-banks' efforts, to which the Bank of England contributed, to raise a loan to Brazil during its currency

[68] M Hall, *Financial Deregulation, A Comparative Study of Australia & the United Kingdom*, Basingstoke, Macmillan Press Ltd (1987) at p. 114
[69] Bank of England Report and Accounts 1990, at p. 11
[70] The justification for the support can be highlighted by Evidence given to the Wilson Committee as background to the "lifeboat operation". The evidence relates to Slater Walker and Edward Bates & Sons. Bank of England (1978) op. cit., n. 57, at p. 235
[71] C A E Goodhart and H Huang, 'A Simple Model of International Lender of Last Resort', Discussion Paper No. 336, Financial Markets Research Centre, London School of Economics October 1999

crisis.[72] The BIS is renowned for its role in developing best practice in the regulation and supervision of internationally active banks. This role emanates from the 1970's financial crisis, which made many regulators of banking, especially in the UK, recognise the importance of international co-operation. This led to the BIS becoming a forum for such co-operation through the Committee on Banking Supervision (originally called the Cooke Committee). Even though the BIS has a restricted-membership practice, its role in developing policy is second to none. The Committee's Core Principles for Effective Banking Supervision are deemed the blueprint for an effective system of banking supervision.[73]

The IMF has a membership of 183 countries. This membership, is much wider than the BIS's, in some respects a recognition that economically and politically diverse countries have unique and characteristic needs. Over its fifty-five-year history, the IMF, an organisation under the wing of the United Nations, has been at the very forefront of the provision of support to economies. This role has, in many respects, evolved from its initial responsibilities for facilitating the balanced growth of international trade in an environment of stable exchange-arrangements. The responsibilities of the IMF centred on the objectives of correcting adverse balance-of-payments and ensuring economic stability. Its policy of structural change has some similarities with the support-and-crisis management of an LOLR. The IMF provides such support on a case-by-case basis, by means of its Stand-By Arrangements. It has also established an Emergency Financing Mechanism to provide immediate aid to countries in rapidly-accelerating crisis situations. An IMF support package typically reauires changes to the economic objectives and policies of a recipient state, which tends to curtail that state's decision-making powers. The IMF operates on the principle of 'conditionality', which is its means of imposing its perception of what is needed to rectify the economic ills that, again in its perception, were the causes of a state's balance-of-payment problem. Its conditions can be despotic, often demanding measures such as a radical alteration to monetary policy, reduction in levels of state intervention in a local economy, or the opening of local markets to foreign competition.

[72] Bank of England, 'Bank of England Participation in BIS Loan to Brazil', *Bank of England Quarterly Bulletin*, May (1999) 138
[73] Chapter 3 Legal Aspects of Prudential Supervision at p. 74

'Systemic risk' is the notional possibility that a crisis can mushroom to catastrophic proportions. However, whether such an occurrence is also a contagion risk is, according to Kaufman, exaggerated. But he concedes that systemic risk warrants some form of central deposit-insurance scheme.[74] The recognition that a condition of systemic risk carries a potential for impacting as international economic crisis warrants a clearer understanding of the risk of contagion. The Mexican and Asian crises illustrate that the threat in the risk of contagion is in the potential for over-spill from one market to other markets that are heavily exposed to it. The difficulty in providing support in such a situation is that such a move would constitute the further risk of creating moral hazard internationally: the international community would be contending with a crisis born of the economic-policy failures of one state (or of a few states).

The main cause of the financial crisis of the mid-to-late 'nineties was the loss of confidence in particular foreign markets. The three broad areas of crisis bear similarities. In the case of Mexico, the Peso crisis in 1994-1995 followed the introduction of a number of new economic-policy initiatives based on a free-market model.[75] The crisis required a very large support package – 'tens of billions of dollars' – for overcoming liquidity problems and containing loss-of-confidence rather than seeing it spill over to other countries' emerging economies. The BIS and the IMF assembled the content of the support package, with particular assistance from the US. Mexico was required to devise its own internal rescue plan for ensuring its future short-and-long-term financial stability.

The Asian and Russian financial crises followed the Mexican one. The major catalyst of the Asian crisis was the collapse-of-confidence in the Thai financial markets. Indonesia and South Korea followed, in regional domino effect. Authorities in the various countries provided liquidity support to the financial markets but also closed down insolvent banks and merged pıoblem institutions. This process required the authorities to sell assets in various restructuring programmes. According to a

[74] G Kaufman, 'Bank Failures, Systemic Risk and Bank Regulation', Vol. 6, No. 1, *Cato Journal*, (1996) at p. 7: http://www.cato.org/pubs/journal/cj16n1-2.html *cf* D Sheonmaker, Contagion Risk in Banking, Discussion Paper No. 239, Financial Markets Group, London School of Economics March 1996 at p. 2

recent US General Accounting Office (GAO) report, the crisis led to sixty-six bank closures in Indonesia, eighty-six financial-institution closures in Korea and fifty-eight assorted closures in Thailand.[76]

Decisions about whether the LOLR will be engaged will derive from the breadth of the concern for financial stability. This is especially so when liquidity pressures are experienced in the financial markets. The power to exercise the LOLR function is not prescribed in formal rules but is a discretionary power to be exercised in order to 'avoid a serious disturbance in the UK economy'.[77] The risk of moral hazard from the exercise of the LOLR function is a particular concern, because of the indiscriminate way it can benefit those who have acted in an imprudent manner. This concern is also prevalent in the application of the formal safety mechanisms associated with insurance schemes or implicit-deposit insurance schemes. These schemes are formalised to cater for the small depositor rather than for the sophisticated depositors and investors in the wholesale markets. Its domain is the sector where financial-stability problems, like those experienced in the secondary banking crisis, tend to occur. The purpose of these schemes, like the LOLR function, is to ensure confidence in the financial markets and reduce the risk of a systemic crisis within the payment system.

### 2.5 The Key Features of Deposit Insurance Schemes

The UK was not the first country to introduce a deposit-insurance scheme.[78] The US introduced its deposit protection scheme after the Great Depression emanating from the stock-market crash of 1929. In response to a huge collapse of nearly 9,000 banks, the US introduced the Banking Act 1933, which brought into being the federal deposit-insurance system. (Some States had a DIS as early as the 1800s.) The international crisis experienced in the 1990s had precipitated the formation of a large number of deposit-insurance schemes in all continents (demonstrating a recognition of the importance of a formal safety net) to reduce the

[75] GAO Report. Mexico's Financial Crisis: Origins, Assistance and Initial Efforts to Recover, February 1996, GAO/GGD-96-56 at p. 110-114
[76] GAO Report. International Finance: Actions Taken to Reform Financial Sectors in Asian Emerging Markets, September 1999, GAO/GGD-99-57
[77] MoU op.cit, n. 19, at p. 39, para., 11
[78] For a specific overview see: R MacDonald, *Deposit Insurance*, Centre for Central Banking Studies, Handbook No. 9, Bank of England

likelihood of systemic risk from bank runs and to maintain market confidence. However, it would be wrong to suggest that a deposit- insurance scheme on its own is capable of safeguarding confidence. The lessons from previous episodes of financial crises highlight the importance of averting moral hazard by introducing formal regulation and supervision that ensure the disciplined conduct of the banking industry. In terms of the measures taken to secure confidence, the secondary banking collapse was no different from the one experienced in the 1990s.[79]

The drive for introducing a safety net in the US is similar to that in the UK: both are re-active measures for building confidence within the financial markets. The UK established the Deposit Protection Scheme upon the introduction of the Banking Act 1979. The Government's initial reason for the fund was not necessarily based on the interests of consumers, but rather, on wider economic interests. The deposit-protection fund aimed to provide an additional, more formal safety net for banks in their pursuit of business considered 'valuable to the economy as a whole'. This was to act as a measure to safeguard deposits from the potential risks posed by the accompanying policy of pursuing new forms of business.[80] The deposit-insurance fund secures very narrow interests, i.e. designated deposits. In contrast to the LOLR, this provides a wider guarantee of safety for banks against a systemic financial crisis. Moreover, the insurance scheme is limited to those members who have contributed to it. It does not, therefore, provide the wider financial community the same protection.

The Deposit Insurance Scheme is formal and regulated. It is normally established as a separate body with its own powers to manage and administer the insurance fund. The Deposit Protection Scheme in the UK was no different. The Deposit Protection Board (the Board) under the Banking Act 1987 was a separately-incorporated body which managed the UK Deposit Protection Fund.[81] The Board included the Governor, Deputy Governor, the Chief Cashier of the Bank and three *ex officio* members. In the intervening period, the Chairman of the FSA served as the Chair of the Board with other members of the FSA, and the Deputy Governor of the

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[79] A reaction to the financial crisis of the 1980s and 1990s was to implement an effective safety net see: G G H Garcia, *Deposit Insurance: A Survey of Actual and Best Practices*, Washington DC, International Monetary Fund (WP/99/54) April (1999)
[80] The Licensing and Supervision of Deposit-Taking Institutions, London, HMSO Cmnd 6584 August 1976 at p. 6

Bank was responsible for financial stability. The new composition of the Board highlights the inherent interdependency of banking regulation and financial stability in terms of insuring against a systemic bank run. More importantly, it reduces the likelihood of moral hazard. The Board has traditionally been composed of members from within the industry, which could raise concerns about the independence of the Board in terms of regulatory capture. When the function of the Board and the Fund was to serve the public interest, it would have surely been appropriate to have an independent representative with no ties to the industry on the Board.

Any insurance scheme would require the ability to raise funds for performing its responsibilities. Funds could be entirely supplied by the government or funded by the industry itself. However, in order to ensure some market discipline, it is considered more appropriate for the industry to fund the insurance scheme because that is thought to be conducive to reducing the likelihood of moral hazard. The contribution is minimal in proportion to the overall deposit base. The Board had the responsibility for obtaining the funds from those institutions designated as 'contributory institutions', which included institutions incorporated in the UK and authorised by the FSA and those institutions incorporated outside the EEA, which are also authorised by the FSA.[82] The 'contributory institutions' are responsible for providing various forms of contribution, calculated by the Board on the institution's deposit base, to the Fund. The 'initial contributions' were only a part of the actual contributions made.[83] 'Contributory institutions' also supplied further payments when the Fund was less than £3 million.[84] In such circumstances the Board could levy 'further contributions' to get the Fund back to the original £5 million provided by the government. The 'contributory institutions' were also required, on occasions, to provide 'special contributions' so that the Fund can meet emergencies.[85] The size of the fund seems small in comparison with the size of the industry. Possibly, the fund size reflects the overall stability of the market or the reluctance of the industry to contribute to it.

[81] 1987 Act s. 50
[82] Ibid., s. 52(1)-(7)
[83] Ibid., s. 53
[84] Ibid., s. 54
[85] Ibid., s. 55

Under the Deposit Protection Scheme, the insolvency of an institution was determined either by the Authority, a court ruling, a non-EEA court ruling, or an EEA competent authority.[86] The Courts in *Re Chancery*[87] accepted a speedy request for an administration order under the Insolvency Act 1986, in accordance with s. 8(3) of the Act.[88] This was to avoid a run on the bank assets in the event that difficulties become publicly disclosed.[89] The Court understood that banks could experience problems if their difficulties were publicly disclosed. This led to the rare decision that the case was heard *in camera*.[90] The UK Board, unlike the boards of some Deposit Insurance Funds, actually facilitated the restructuring of the contributory institution. In the past the Bank has actually acquired authorised institutions in its wider capacity. In order to ensure the effective realisation process. In 1994 the Bank acquired the National Mortgage Bank which required support in the region of £105 million.[91] The Rules governing the Scheme do not exonerate the failed institution from its liability to depositors after it has been deemed insolvent. Moreover, any payment to the depositor from the insolvent institution or from the Fund would be less than any compensation payment made by the Board or the insolvent institution.

Certain deposits are normally excluded from the Deposit Insurance Scheme. These include deposits from other banks, financial institutions, public authority deposits, corporate deposits, deposits from directors and group deposits. Deposits from criminal proceeds are normally excluded and are excluded from the UK Scheme. The payment under the UK scheme was also capped at a maximum limit, currently £20,000 or equivalent to 90% of the protected deposits.[92] This is legitimated on the grounds that it ensures consumer discipline in that depositors do not place deposits with risky institutions. The reason for this could only be valid, if the depositor had the information to make such a decision. Therefore, the case for co-insurance is flawed when the risk to contributory institutions is not clear.

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[86] Ibid., s. 59

[87] *Re Chancery* [1991] op. cit., n. 44, at p. 712

[88] Pursuant to the Banks (Administration Proceedings) Order 1989, SI 1989/1276 24 July 1989

[89] *Re Chancery* [1991] op. cit., n. 44, at p. 713, citing *Re Rowbotham Baxter Ltd* [1990] BCLC 397

[90] *Re Chancery* [1991] op. cit., n. 44, at p. 714

[91] Bank of England Report and Accounts (1995) at p. 12

[92] 1987 Act s. 60. Subsequently, insolvent institutions are liable for respective compensation payments, see also s. 62 of the 1987 Act

### 2.5.1 The FSA Compensation Scheme

The existing Deposit Protection Scheme will be fused with other compensation schemes, such as investment business, building societies and insurance compensation schemes. Pursuant of s. 212, FSMA 2000, a separate body corporate called the 'Scheme Manager' will be established and will have a broad range of powers to administer compensation to those who have claims arising from regulated activities. The FSMA 2000 provides the 'Scheme Manager' with a number of broad powers: to impose levies on authorised persons (s. 213(3)(b)); to set up different funds to meet the different types of claims (s. 214); to devise provisions relating to insolvency of regulated firms (s. 215); to publish an Annual Report (s. 218); to request information and documents (s. 219); to inspect documents held by the Official Receiver (s. 224). The FSMA 2000 simply provides the framework for the compensation scheme. It is uncertain whether the scheme will retain the idea of co-insurance, which puts a degree of responsibility on the 'claimant'. Since FSMA 2000 is underpinned by the objective of safeguarding the interests of consumers, it will be interesting to see whether the limit of co-insurance is changed in the consumers' favour.[93]

The aim of depositor-insurance schemes is to reduce the panic and bank-run crises that typically occur in the retail sector. The depositor-insurance scheme is triggered when an insolvency situation arises, whereas the LOLR function traditionally provides support when liquidity problems arise. It is difficult on occasion to distinguish whether a bank is experiencing a liquidity or a solvency problem. Therefore, the question of whether support should be provided surely warrants some form of public scrutiny, if only to determine whether it is being given in the public interest or simply for shielding the industry from its own imprudence. There is a lack of transparency in support arrangements. For example, the UK support operation in 1991 was only publicly revealed some years after the crisis was averted. A mini lifeboat was launched because of a perceived systemic risk in the potential failure of a group of small banks.[94] The collapse of real- estate values exposed a number of small banks to the threat of collapse. In order to avert this, the Bank provided liquidity and

[93] FSA, *Consumer Compensation: A Further Consultation*, Consultation Paper, Financial Services Authority, June (1999) at p. 15, para., 4.7-4.8

did not disclose publicly that it had done this. Although the Banking Department's financial statements reported the support, it was not explicit who its recipients were. The lack of transparency in such procedures is specifically legal:

> *"[I]n some cases confidence can be best sustained if the Bank's support is disclosed only when the conditions giving rise to potentially systemic disturbance have improved."*[95]

This instance of the granting of support raises questions about the existence of consistency among decisions to give support. The parallel concern is about 'regulatory capture': Are support arrangements made on legitimate economic grounds or simply in the interest of the industry? However, such concerns can be exaggerated when one considers the social costs of not doing anything.

### 2.6 Moral Hazard

Moral hazard brings to the forefront the importance of appropriate prudential regulation of banks to maintain market discipline and overall financial stability. Extending support ultimately requires agreement from the government of the day, particularly when the value of the support fund is made public. Past experience shows that the Bank has been inclined to provide support in order to avert systemic risk, and to support institutions linked with problem banks through business. Political pressure can also be great where reputations of financial centres are so important. The discretionary nature of support decisions is such that support can be exercised in circumstances which do not actually warrant it. Some might be ones where an institution is insolvent but other factors are also at play. These could be: ruminations about the size the impact on the market if the institution in question should collapse; an inclination to accommodate political pressure; the institution carries too-big-fail connotation.[96] In short, the uncertainty surrounding the LOLR function causes

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[94] A Logan, 'The Early 1990s Small Banks Crisis: Leading Indicators', December, *Financial Stability Review*, (2000) 130-136

[95] Bank of England Act Report 1992

[96] F Soussa, 'Too Big to Fail: Moral Hazard and Unfair Competition?' in L Halme, C Hawkesby J Healey, et al, *Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market* Discipline, Centre for Central Banking Studies, Bank of England, London (2000) at p. 5; M Roth, ''Too-Big-To-Fail' and the Stability of the Banking System: Some Insights From Foreign Countries', October, *Business Economics*, 43-49; this also leads to the concern of concentration of financial power, see: C A E Goodhart, 'Bank Insolvency and Deposit Insurance: A Proposal', in P Arestis, & Contributors, *Contemporary Issues in Money and Banking*, Basingstoke The Macmillan Press ltd (1988) at p. 50

concern about its arbitrary decision-making which is an *implicit criticism*, the Deposit Protection Schemes can avoid.

The BIS has paid little attention to the issue because it is reluctant to encourage the establishment of Deposit Protection Schemes.[97] In many respects this is in contrast to the actions taken by the IMF to avert the financial crisis experienced recently. A recent IMF study suggests that Deposit Insurance Schemes do not create financial stability and in some instances create instability.[98] Another concern with DIS is highlighted by the crises considered earlier, particularly the cases of Indonesia and Thailand, where informal arrangements were not fully understood by the authorities, nor were they ale to make clear who was eligible under the scheme. This raises concern about *implicit guarantees to avert a financial crisis*. In the case of Indonesia, a wide-ranging guarantee was given to the market, which did work, although it also undermined the importance of institutional responsibility and exacerbated concerns about moral hazard. The central aims of the financial-support package to restore market confidence were: to ensure that reserves are adequate; introduce fiscal change; change monetary policy. Furthermore, important structural changes were also implemented, such as restructuring the financial sector and improving financial regulation to bring it into line with the Basle principles of banking supervision.[99]

Moral hazard is a concern also in the granting of international support packages. It is especially worrying in the style of support that the IMF gives, which in creates 'free rider' issues and does not assess the actions of financial intermediaries in the markets. However, this is somewhat countered by the stringent policies which it has made governments adopt. A recent GAO report contends that the IMF bailed-out of large international banks and other private lenders raised a number of concerns:

> *"This activity has raised concerns about the efficiency of the international financial system by shielding private sector participants from the risks inherent in their investments."* [100]

[97] Compendium of Documents Produced by the Basle Committee on Banking Supervision: Volume Three. International Supervisory Issues. Basle, *Deposit Protection Schemes in the Member Countries of the Basle Committee*, March 1997 at p. 90
[98] A Demirguc-Kunt and E Detragiache, *Does Deposit Insurance Increase Banking System Stability?*, International Monetary Fund, Washington DC (2000) at p. 25
[99] See Chapter 3 Legal Aspects of Prudential Supervision at p. 73

In such circumstances, there is need of a caveat for institutions tempted by certain growth markets. Ultimately, the responsibility is with the countries themselves to avoid the risk of moral hazard. What can be seen by comparing countries is the inconsistency with which LOLR is provided and the blur between liquidity and solvency problems. This raises the issue of an international consensus as to when support is warranted so that political pressures do not reduce the impact of the lessons of market failure. The lack of transparency in the provision of LOLR, called 'constructive ambiguity', is itself a mechanism to reduce moral hazard by ensuring that banks do not become complacent but act in a prudent manner.[101]

**2.7 Process of Re-Regulation: The Objectives of Regulation**

The Bank has long exercised a surveillance responsibility over many parts of the UK's capital markets for the purpose of managing monetary policy, and its relationship with the markets grew. It also ensured the orderly conduct of the wholesale money-markets on a basis of mutual co-operation. More importantly, the Bank, with its policy of dismantling barriers to specific financial markets, was the key architect of the growth of financial conglomerates. The process of deregulation provided the catalyst for a single super regulator. However, the transfer of banking supervision from the Bank to the Financial Services Authority (FSA) has been proposed a number of times.[102] It was inspired by resentment of the Bank's approach to supervision and by the high-profile failures. A further concern was the possible conflict of interest between the Bank's responsibility for ensuring the competitiveness of the UK capital markets and its responsibility for banking supervision.[103] The Labour Party's manifesto, up to the election in 1997, had declared its intention to overhaul the system but did not indicate that this would include the banking-supervision arrangements.[104] This only manifested itself when Labour succeeded the Conservative Party in the general election in 1997. The announcement of the changes

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[100] *Cf* with Bank of England, 'The Asian Crisis: Lessons for Crisis Management and Prevention', *Bank of England Quarterly Bulletin*, August, (1999) 285-295 at p. 290 (Speech by Prof. Brealey)
[101] E G Corrigan, *Statement Before US Senate Committee on Banking, Housing and Urban Affairs*, Washington D C (1990); C A E Goodhart and H Huang, 'A Model of Last Resort', Discussion Paper 313, Financial Markets Group, London School of Economics, January 1999 at p. 33
[102] See, First Report, *Role of the Bank of England*, (1993), para., 102-103, even though, it decided that the Bank should hold onto the responsibility of banking supervision.
[103] Report One, *The Role of the Bank of England* (1993)
[104] Labour Party Business Manifesto: *Equipping Britain for the Future*, April 1997 at p. 4

was made in the new Parliament. The Chancellor of the Exchequer emphasised that reforms were necessary to:

> "*...ensure the future confidence of investors small and large, and the future success of the increasingly integrated financial services industry on which so many British jobs now depend.*" [105]

The Chancellor pointed out the importance of the reforms which would include the transfer-of-banking supervision. The Bank was meant to be somewhat appeased by the fact that the Chancellor wanted it to be fully involved in the new proposals. The Governor's public opposition was cautious, concentrating on the unique position of banks in the economy. It was suggested that the unique nature of banks rendered them open to certain risks. They were, for instance, vulnerable to contagion. This vulnerability obliged the central bank to monitor banking institutions more closely than other financial institutions.[106]

The inclusion of the Bank in the development of the new plans is no surprise, considering the fact that it had traditionally been very influential in the erection of banking and securities regulation in the City. This has manifested itself in a number of ways to create a unique City culture of regulation based on the notion of *laissez-faire* supervision.[107] Central in this scheme was the appointment of chairpersons deemed acceptable to the regulatory community to head the regulator. Therefore, the appointment by the Blair Government of Howard Davis, deputy chairman of the Bank of England, as the Chairman of the FSA seemed natural. It had moulded conceptual and philosophical tenets of that community. The Chancellor declared that by this appointment he was drawing upon the resident expertise of the Bank.[108]

### 2.7.1 The Objectives of Regulation

The new regime has the overall regulatory responsibility for deposit taking business, investment business, (encompassing regulation of recognised investment exchanges) and insurance business. The new regime amalgamates the central components of any regulatory regime designating a regulatory authority to make rules

105 House of Commons Debates, 20th May 1997 col. 510
106 Bank of England, "Transfer of Banking Supervision", *Press Release*, 20th May 1997
107 Chapter 1 Evolution of Banking Regulation and Financial Services Regulation
108 House of Commons Debates, 20th May 1997 op. cit., n. 105 col. 511

governing regulated and prohibited activities, authorisation and exemption, continuous supervision, enforcement powers and the establishment of an appeal process. The introduction of the Financial Services and Markets Act 2000 transfers to the FSA:

> "*...the regulation of financial services and markets; to provide for the transfer of certain statutory functions relating to building societies, friendly societies, industrial and provident societies and certain other mutual societies; and connected persons.*"[109]

The new regime focuses attention primarily on consumer protection rather than on the efficiency of the financial markets, which distinguishes it from the previous regulatory order.[110] However, the FSA is not promoting excessive regulations for the protection of consumer interests. Rather, it meant to construct a regulatory order that engages a suitable mix of past and present techniques for the purpose of consolidating its future role in the pursuit of the new, formally-stated objectives.[111] An over-emphasis of consumer-regarding regulations would not have been appropriate, first because no amount of regulatory order is capable of protecting consumers from all risk, and secondly, a regulatory order should not attempt to attain to make an objective of absolute protection. Instead, the new regime built on the central tenets of the past: a regulatory order should be sufficiently flexible to accommodate change, ensure the safety of consumers and maintain confidence in the financial system.

The FSMA 2000 breaks with the past in that 'self-regulation' is replaced with direct statutory regulation, but it retained an appreciation of the importance of practitioner involvement in the policy-making process.[112] The new regime required the FSA to establish a formal panel of practitioners with a general duty to consult them as the panel capable of ensuring the consistency of its policy with market developments. In many ways, what the new regime provided was the best of 'self-regulation' practice: close links with the industry and a competent adviser-base for

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[109] Preamble FSMA 2000

[110] FSA, *Financial Services Authority: An Outline*, Financial Services Authority, London (1997) at p. 30

[111] FSA, *Financial Services Authority: Meeting Our Responsibilities*, Financial Services Authority, London August (1998) at p. 14

[112] FSMA 2000 s. 9

policy formulation, without ceding the power of authorisation, supervision and enforcement to that base. The establishment of a consumer panel provided balance in the policy-formation process and avoided a perception of regulatory capture in the interests of industry.[113] The initial policy-statement suggested that the practitioner-based panel should have an advisory role, and the consumer panel should 'aid consumer involvement' in the FSA's policy-making process. This would have created an imbalance in favour of practitioners. In the FSMA 2000, the panels were placed on equal footing. This was a positive step, entraining a broad range of interests for building the FSA's regulatory policy.

Designating regulatory objectives is beneficial because it provides a basis for assessing whether regulators are meeting their responsibilities. It is suggested that designating particular objectives assists regulatory decision-making. However, the *de jure* objectives are broad and effectively build on existing *de facto* regulatory objectives. Therefore, the introduction of objectives is no new thing: statutory regimes have normally reflected implicit regulatory objectives. The Banking Act 1987 gave the Bank primary responsibility for ensuring that it kept up with industrial developments and innovations, and a general duty to safeguard the interest of depositors.[114] In the post-Barings period the Bank's inclination was to construct objectives particularly capable of reinforcing its supervisory duty. The central one of these was being to 'strengthen, but not to ensure, the protection of depositors'. This was based on the pragmatic view that banks could fail and that banking supervision could not guarantee banks' deposits.

The FSMA 2000 outlined the FSA's responsibilities as the broad regulatory missions that was to tend market confidence, public awareness, the protection of consumers, and the reduction of financial crime.[115] The new regime focused the FSA's attention on the importance of maintaining confidence in the financial markets, exchanges and regulated activities. The responsibility of the FSA was to support the Bank and the Treasury in the pursuit of financial stability by focusing its attention on the prudential supervision of authorised institutions. This incorporated a huge array of

[113] Ibid., s. 10
[114] 1987 Act s. 1(1) and (2)
[115] FSMA 2000 s. 2(2); see also FSA, *Meeting Our Responsibilities*, (1998), op. cit., n. 110, at p. 16-18

regulatory activities, all of them potentially capable of impacting on confidence. The interdependence of financial stability and the regulation of financial institutions requires close co-operation between the Bank and the FSA, and the manifestation of this is in the MoU.

The objective of cultivating public awareness is considered to be an innovation, but its innovative importance is elevated only because of the pension mis-selling scandal and the sale of endowment mortgages in the latter part of the last century. It has always been a widely-held view that a consumer who is aware of the risks in various financial products is one that can make good investment decisions. A facet of the objective of cultivating awareness is consumer protection. The FSMA 2000 has indicated that the FSA is briefed to secure the appropriate degree of protection. To fulfil this brief, the FSA will have to estimate the variety of risks in the various forms of regulated products, then determine the appropriate methods for reducing risk to consumers without increasing the cost of pertinent products.[116] The principle of *caveat emptor*, advocated by the Chairman of the FSA and enacted in the FSMA 2000, alarmed consumer groups. To dissipate their alarm, care was taken to elucidate the *caveat* principle as one that does no more than put a broad onus of duty on consumers to take responsibility for their investment decisions, and as one that avoids exploitation of vulnerable sections of the public.[117] The FSA gave clear re-assurance that the distinctions 'retail' and 'wholesale' will be maintained, and that therefore the wholesale end of the market will not be overburdened with regulations of which the sole purpose is to safeguard unsophisticated participants.[118] In the wholesale markets, a lighter approach to regulation is encouraged, one that expresses itself in broad terms rather than as prescriptive conduct-of-business rules.[119] The new regime introduced also the formal objective of reducing financial crime, as much on the money-laundering level as on the wider levels of fraud, dishonesty, market

[116] Ibid., s. 5(1)
[117] H Davies, Chairman Financial Services Authority, 1999 Travers Lecture, London Guildhall University Business School, 'Building The Financial Services Authority: What's New?', March (1999) http: www.fsa.gov.uk/speeches/1999 march 11031 1999.htm at p. 4;
HM Treasury Response to the Joint Committees First Report
http: /www.fsa.gov.uk development/legal f...t_committee first_report/hmt_response.htm at para., B
[118] This approach is essentially based on a wide definition of "consumer" FSMA 2000 s. 5(3) advocated by The Treasury Committee, see Third Report, *Financial Services Regulation*, The Treasury Committee (1999) at p. x para., 10
[119] FSA, Discussion Paper, *Differentiated Regulatory Approaches: Future Regulation of Inter-Professional Business*, Financial Services Authority, London October (1998) at p. 5 para., 1.7

misconduct and statute-specified FSMA 2000 offences. Designated persons are charged with the responsibility of putting in place measures suitable for arraigning financial crime.

Further FSMA 2000 introduces a number of regulatory principles intended to underpin the new regulatory objectives: It formalised the traditional *de facto* regulatory measures of the previous regulatory and supervisory authorities. For example, the Bank had maintained that its style of supervision ensures the competitiveness of the UK financial markets by maintaining a 'level playing field' across financial sectors and jurisdictions. However, there was a perception that the bank's style of supervision was one that encouraged a lax regulatory environment. Yet the FSA itself did not seem bothered by this. Under the FSMA 2000, the FSA has a formal obligation to have a regard for the ability of financial markets to compete with their international counterparts. This obligation requires the FSA to dismantle obstacles that might impede or distort that ability to compete. In short, the FSA is itself required to maintain the 'level playing field'.[120]

Its objectives place a duty of conduct upon the FSA, and this makes it accountable for its decisions in terms of those objectives. Being declared objectives, they are the yardstick measures to determine whether it is fulfilling its responsibilities. This level of accountability is a positive development upon that of the previous regime, whose objectives had never received formal statement and could therefore not be the arbiters of its performance. However, this new level of accountability of the FSA is somewhat diminished by its statutory immunity from prosecution for the tort of negligence. In view of the FSA's position in law in this matter, its objectives do not elaborate a list of formal duties they are obliged to fulfil. Rather, those objectives a simply expressions of intent. Though the political process and the formal panels will play a significant part in the accountability process, individual redress is not provided for. In its discharge of functions the FSA must take into account particular principles, such as the efficient use of regulatory resources, when it deliberates upon the proper allocation of resources. The FSA prefers cost-benefit analysis in its determinations of

[120] FSMA 2000 s. 3(e), (f) and (g); it is not surprising that the Association of British Bankers advocated competition to be an objective of regulation within the new regime, see Joint Committee on Financial

regulatory action. However, while such an approach may enhance efficiency in decision-making, it is short on public-interest considerations, its primary concern being cost. It must also be mindful that it does not undermine innovation in its process of regulating activities, so that its regulations are not seen to be inhibitors of the development of new forms of legitimate business.

## 2.8 Conclusion

This Chapter has analysed the role of the Bank in ensuring financial stability. That role had evolved over a long period and consolidated in the 19th Century, its central function being the provision of price and financial stability. Its role in banking supervision evolved from its responsibility for ensuring financial stability within the economy. The growth of this separate and equally important facet of the Bank's role was fuelled by the importance of ensuring that participants in financial markets act in an adequate manner (prudentially) to maintain confidence. The introduction of the Bank of England Act 1998 brought about changes to mark its independence in monetary-policy decisions. Pursuant of this Act, it was able to operate on a rules-based principle, rather than on the traditional discretion-based one that had left it open to significant political intrusion.

Access to support from the central bank has traditionally been the sole preserve of the banking system, it being seen as the industry most vulnerable from disturbance to the payment system as well as the one most capable, through failure, to threaten economic stability. A financial crisis can occur in the domestic or the international financial markets. The threat of a systemic failure is the most severe, because it can create liquidity problems even for solvent institutions. The role of the LOLR function in the whole financial system is such that the Bank has to develop an understanding of the systemic effect on the economy not only of the banking sector but also of the securities houses, investment banks, insurance companies and pension funds. Whether financial firms beyond the banking sector are eligible for support is a separate matter, but it is worth noting that those firms are developing an ever-increasing potential for posing systemic risk.

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Services and Markets, First Report, (1999), Appendix 13, para., 4; see also Chapter 3 Legal Aspects of Prudential Supervision

The LOLR function has grown in significance and developed an international dimension with the globalisation of financial markets and the role of the IMF in providing support to countries in times of financial crisis, albeit not in the classic way but rather as crisis manager. Evidence has been tendered (above) to the effect that moral-hazard problems can arise from the provision of support, both on the national or the international front. This can only be curtailed if an effective regulatory and supervisory regime is in place to ensure that support is granted only in the most exceptional and meritorious of circumstances. To ensure consistency in the provision of support, it is crucial to have some form of international consensus on when support should be given, and for what purpose. This requires a clear understanding and definition of 'systemic risk': a clear understanding of 'systemic risk' enables lucid determination of when support, directed into a particular context, will function in that context to maintain confidence in the whole economic system. It was argued also (above) that the roles of regulation and supervision and the LOLR function are interdependent, and that therefore an examination of both is essential in a study of regulation.

The most significant change introduced by the 1998 Act is obviously the transfer of banking supervision to the FSA and the unification of regulation in the financial-services industry. This change was inevitable in the wake of events during the 1980s and 1990s, such as the dismantlement of barriers to financial markets which were once the preserve of specialist institutions. However, specialist regulatory bodies remain the order of the day, focusing on specific forms of risk and on the consumer (depositor, investor or the assured). The fusion in the financial services industry resulted in clients having access to a one-stop-shop of financial products that suit their needs. But this does not ensure a more efficient provision of those services. The FSA is essentially an amalgamation of pre-existing regulators and processes. For example, authorisation, supervision and enforcement are the central cogs of the regulatory machine into which the specialist skills of supervision and surveillance have been built. The FSA recently noted the gains in efficiency that have come about with the establishment of a single regulator.

The sophistication of the financial industry prevents the possibility that the structural changes outlined above will create a regulatory mechanism purged of all evils that occasion instances of regulatory failure. It is important to see regulatory failure as the accident to which in a complex industry is prone. (In that sense, instances of its failure are natural phenomena.) The complexity of the financial institutions, and the significant risks generated by their business, has placed ever-greater burdens on the regulatory regime. It has posed new regulatory and supervisory problems with which the traditional approaches to regulation could not have dealt, mostly because they lacked an understanding of non-regulated activity.

Regulation in the City of London has traditionally been based on informal structures such as its competitiveness and practitioner involvement. However, 'capture', and whether the market alone can provide safety for all interested parties, was an obvious concern. The adoption of a broad range of objectives and principles reduces such concerns, particularly when consumer interests are placed on an equal footing with the financial industry's, and thereby, become part of the broad spectrum of interests that measure regulatory performance. The formal objectives and principles enacted in the FSMA 2000 will be crucial in determining what is legitimate in the regulation of the various types of financial services. So competitiveness will not necessarily remain the mainstay of banking. Other concerns, such as consumer confidence and awareness, will warrant consideration in the design of regulation and supervision, and they might manifest in an appropriate transparency of decision-making, especially in the area of enforcement.

The growing complexity of risk within financial market warrants consideration of whether regulation alone is competent to ensure confidence in a financial markets where regulatory failures are inevitable. In Chapters 3 and 4, prudential regulation is analysed extensively in order to show that effective corporate governance is the only appropriate mechanism in a sophisticated regulatory regime for avoiding regulatory failure.

# Chapter 3

# Legal Aspects of Prudential Supervision

## 3.1 Introduction

Prudential supervision is a crucial part of the command-and-control strategy that was developed into the 'risk-based approach' of regulation. Authorisation acts as the central mechanism for controlling the activities of businesses operating in areas of particular public interest. The discretion-based approach underpins prudential supervision and has played a significant role in providing regulated institutions with a path for undertaking the non-traditional 'unauthorised activities' to form bank-financial conglomerates.

In this Chapter, Section 1 examines the general purpose of banking regulation, in particular, the competitiveness of a financial centre and the attainment of competitive equality between banks and non-bank securities firms to provide a 'level playing field' that safeguards the interests of 'home' and 'host' countries. Section 2 focuses on the authorisation of deposit-taking business regulated by the Banking Act 1987 and the FSMA 2000. Sections 3-5 consider the role and aims of the above, with particular attention to the various risks to banks from traditional credit-risk factors, and the growing effect of market-risk. The regulatory response to these risks and to other formalised risks are analysed, in particular, the guidelines relating to solo consolidated supervision, capital adequacy and large exposure. Prudential measures are examined in the light of the huge changes that have taken place in the assessment of market risk. Reference is made to the new incentives for the regulated to assess the risks they are exposed to by adopting their own internal risk-measurement models. Section 7 draws the strands together and advances general conclusions.

### 3.1.1 Definition of Supervision and Surveillance

The procedures of supervision and surveillance have traditionally controlled the activities of banks. However, neither the Banking Act 1987 nor the FSMA 2000 define these two forms of social control. They must therefore be understood literally. 'Supervision' has been defined as:

> "*...general management, direction, or control; oversight, superintendence.*"[1]

This definition gives prominence to the existence of an authority of which the purpose is to instruct in a particular course of action or to demand a particular sort of behaviour in the pursuit of a practical purpose. 'Surveillance' has been defined as:

> "*Watch or guard kept over a person etc, esp. over a suspected person, a prisoner, or the like; often spying, supervision; less commonly, supervision for the purpose of direction or control, superintendence.*"[2]

The idea of surveillance complements the idea of supervision because it imbues it with an element of vigilance, thus highlighting the importance of observing those under its authority with a degree of scepticism and intrusiveness. The advent of banking supervision has meant that a significant number of rules and guidance have arisen to explain the procedures of supervision and surveillance. The 1987 Act and the FSMA 2000 provide detailed guidance on this. These Acts offer a good opportunity for observing the relationship between the regulator and regulated in a context that is underpinned by the idea of trust and co-operation, without which the objective of 'supervision and surveillance', or of control to ensure financial stability and depositor protection, could not be attained. 'Trust' in the relevant sense highlights the importance of having confidence in the regulated, so that the regulator can deem the regulated reliable without feeling a need to scrutinise it, and thus confer on it the right to participate in a regulated activity.

Prudence is an integral part of supervision and surveillance, providing the standard-of-care required of the regulated. 'Prudence' connotes 'acting with care based on forethought and careful deliberation to avoid undesirable consequences'.[3] In the law of torts, for example, prudence is seen as a benchmark in the determining of

[1] The Oxford English Dictionary, 2nd Edition (Vol. XVII Su-Thrivingly), Oxford Clarendon Press (2000) at p. 245
[2] Ibid., at p. 309
[3] Ibid., at p. 729-730

whether an individual has acted with reasonable care.[4] The idea of prudence also has particular relevance in the case of directors' duties to determine whether they have exercised 'reasonable care' in the exercise of those duties: Sterling J interpreted directors' failure to verify the soundness of an estimate as an act of imprudence:

> "*...I cannot think the directors acted as prudent men of business, or as they would have done in conducting their own private affairs, in acting on the unsupported statement of their secretary as to the existence of a valuation which he never saw, and thus converting accounts which would otherwise have shewn a loss into accounts shewing a profit...*"[5]

### 3.1.1.2 The General Purpose of Banking Regulation

Banking supervision, which entails a regulatory approach, is implemented to provide against market externalities, manage systemic crises and/or breakdown of confidence in the market. It safeguards the interests of those who participate in the market in areas where the principle of *caveat emptor* is not sufficient to ensure effective decision-making by depositors.[6] Regulation attempts to bridge the gaps in a market-economy which market forces alone cannot close, and which, if left unregulated, can produce de-stabilising effects in an economy. What is clear is that no one reason for regulation really outweighs the other, and that a pluralistic approach in the regulatory strategy is necessary to ensure financial stability. To reduce problems, regulators, through their powers of assessment, determine whether an institution should be authorised to participate in a regulated business. By continuous monitoring, regulators attempt to give public assurance that authorised institutions are complying with the regulatory order. This form of regulation is commonly referred to as 'command and control' and is the traditional approach to banking regulation and supervision of which the powers and duties received formal statement in the Banking Act 1987, and later in the FSMA 2000.

Prudential supervision attempts to ensure that authorised institutions are adequately capitalised to avoid insolvency and liquidity problems arising from changes in market conditions. Regulation tries to maintain confidence in the marketplace by attempting to prevent market forces from undermining the underlying

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[4] *Blyth v The Company of Proprietors of the Birmingham Waterworks* (1856) 11 Ex 781 at p. 782
[5] *Leeds Estate, Building and Investment Company v Shepherd* (1887) 36 ChD 787 at p. 804
[6] Hence a narrow caveat within the FSMA 2000

objectives (stated above). While market forces are the *very basis of banking business*, regulation aims at achieving efficiency in the provision of financial services, at reducing risky and unfair forms of competition, and generally, at preventing a misuse of the market. In the light of this, it is important to note that regulation is limited in terms of what it can and cannot do, and that it does not always succeed in guiding market-response to a particular incident.

### 3.1.2 The Impact of Competition Policy

Competition Policy is an integral part of structuring regulation and supervision. Pursuant of s.2 of the FSMA 2000, the FSA is obliged to consider the implications of its general functions in the light of general competition-policy. Under the Bank of England regime, competition policy was an informal principle without statutory basis. Now, under the FSMA 2000, the FSA has a legal obligation to ensure that competition issues are given appropriate attention. Recent policy-guidance obliged the FSA to carry out an analysis of competition, and on the basis of its findings, determine whether a policy-decision it is contemplating will facilitate competition and innovation in the market[7]. It needs also to estimate the impact of a policy initiative on London (the financial centre), and to assess the costs and benefits of the burdens and restrictions which may arise if that policy were implemented. The FSA operates on a broad, purposive definition of 'competition':

> "*[A] process where the good drives out the bad, where there exists a pressure to decrease prices and to increase quality, and where the entrepreneurial spirit can unfold and innovate.*"[8]

The guide elaborates on 'effective competition' by highlighting the importance of achieving the best possible level of 'social welfare', whether for the consumer or the firm. In general terms, it maintains that through competition, efficiency and costs are improved, hence the importance of not stifling competition.[9] The FSA's competition policy has another facet: It believes that regulation can

[7] Financial Services Authority, *Making Policy in the FSA: How to Take Account of Competition. A guide to competition analysis in financial services*, Central Policy Division, Financial Services Authority July 2000 (Guide to Competition)
[8] Ibid., at p. 15
[9] OECD, *Competition in Banking*, Paris, OECD (1989)

achieve a 'level playing field' for competition between bank and securities firms.[10] It is important for a regulatory regime to promote conditions of competitive equality because it must avoid an image of financial centres as centres of malpractice. The increasing internationalisation of markets and the interaction of various participants in those markets have made the capital-markets much more interdependent. This interdependency is a feature also of specific-product markets such as the derivatives market and the core equities-market (the source of the derivatives), where price movements are closely correlated.[11]

The notion of 'competitive equality' may be considered in two ways: first, (from a domestic perspective) as the right, once authorised, of the various institutions to pursue the same forms of business rather than vie for exclusive 'compartmentalised' sectors; secondly, (on an international perspective) as the harmoniser of international prudential-supervision that controls the level of risk to capital. This dual consideration is crucial for achieving equality of competitive opportunity among different types of financial-institution.

The pursuit of a 'level playing field' for the securities industry and the banks was one of the central issues for the 1990s. The Basel Committee's work made good headway in this direction by proposing best-practice codes both for the setting of prudential controls on the international capital-market to protect it from systemic damage, and for the supervision of the banks/securities business.[12] This inspired regulators to use regulation as a mechanism for advertising quality, thus attracting participants to markets with 'quality' labels,[13] such as the 'Single European Market'.

Basle, the standard-setter in banking supervision, promotes good practice and encourages states to adopt its minimum standards. Regulatory authorities have recognised the importance of converging regulatory standards for preventing systemic failure in one centre from infecting another. However, a point to bear in mind is that 'increase of regulation' may not be the most appropriate measure to advocate,

[10] R Dale, *Risk and Regulation in Global Securities Markets*, Chichester, John Wiley & Sons (1996)
[11] See, SEC Staff Report, US SEC Division of Market Regulation, *The October 1987 Market Break*, chapter 3 at p. 3-6
[12] See section on Capital Adequacy at p. 107
[13] OECD, (1989) op. cit., n. 9, at p. 118

because 'increase' may not serve to stimulate existing market-response, particularly in developed regulatory states such as the UK. Nor should it be assumed that standardised capital requirements on their own can achieve a 'level playing field' across jurisdictions: Other factors exist that work as comparative advantage. For example, a liberal safety-net can place banks from other jurisdictions above the competitive power of banks in a jurisdiction where stricter policy obliges them to hold a greater reserve of capital.[14] The effective status, therefore, of competition-policy, is this:

(i) it allows banking institutions to compete on the basis of the *laise-faire* principle;

(ii) where there is competition there is also monopoly: the survival of the fittest will apply;

(iii) competition policy is almost meaningless in the European Economic Area, because under the Second Banking Directive banks have automatic permission to perform on any European market and it is immaterial whether they are competitive or not.[15]

### 3.1.3 The Role of Basel, the European Union and IOSCO: Norm-Creating Capacity

The development of bank regulation and supervision in the UK must be examined in the context of the work of the Basle Committee on Banking Supervision and the European Community programme for the establishment of a single market. The Basle Committee on Banking Regulation and Supervisory Practices was established after the collapse of Franklin National Bank and Bankhaus Herstatt in 1974, fatalities of foreign-currency dealings. These collapses illustrate how risk can be transmitted from the 'home state' to 'host states' because of the inter-relatedness of banks' wholesale dealings among themselves.[16] The effect of the collapses was felt

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[14] H S Scott and Shinsaku Iwahara, *In Search of a Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States*, Occasional Paper 46, Washington DC Group of Thirty ( 1994) at p. 1

[15] See below European Authorised Institutions under the Second Banking Directive

[16] For an early examination see generally, A Hirsch, 'Supervising Multinational Banking Organizations: Responsibilities of the Home Country', No. 3, *Journal of Comparative Corporate Law and Securities Regulation*, (1981), 40-45; N L Petersen, 'Supervising Multinational Banking Organizations: Responsibilities of the Host Country', No. 3, *Journal of Comparative Corporate Law and Securities Regulation*, (1981), 27-31

in a number of jurisdictions, which forced the recognition that co-operation was needed to manage such disasters by preventative measures to mitigate their impact.[17] Citing the importance of co-operation in the supervision of 'foreign' establishments, the Basle (Cooke) Committee provided a forum for G-10 countries to discuss for assessment and improvement of their early-warning systems,[18] in particular, their ability to estimate adequacy of standards in the structures of 'host' and 'home' institutions. The Basle Committee highlighted the importance of managing transnational banks' liquidity conditions. To facilitate this type of supervision, information about whether a bank is complying with prudential controls needs to be shared.

The growth of the banking industry and the development of new markets created major concerns, related initially to the deteriorating levels of capital, to the ever-increasing complex risks in the developing markets, and to innovations in the variety of financial instruments.[19] The Basle principles were accepted by countries into their own legal regimes to mould their own style of regulation and supervision, and were legitimated on the basis that they are reliably deemed 'best practice'.[20] There

[17] W A Ryback, 'Work of Basle Committee', in R C Effros, (ed.), *Current Legal Issues Affecting Banks, Vol. 3*, Washington DC, International Monetary Fund (1992); J J Norton, 'Appendix – Background Note on the Basle Committee', in J J Norton, *Bank Regulation and Supervision in the 1990's*, London, Lloyd's of London Press Ltd (1991)

[18] W P Cooke, 'Supervising Multinational Banking Organizations: Evolving Techniques for C-operation Among Supervisory Authorities', No. 3, *Journal of Comparative Corporate Law and Securities Regulation*, (1981) 46-65; P C Hayward, 'Prospects for International Cooperation by Bank Supervisors', Vol. 24, No. 3, *International Lawyer*, (1990), 787-801; E B Kapstein, 'Resolving the regulator's dilemma: international co-ordination of banking regulations', Vol. 43, No. 2, *International Organisation*, (1989), 323-347; A K Shah, 'International Bank Regulation – Objectives and Outcomes: An Interview with Mr. Peter Cooke, former Chairman of the Basel Committee, 1977-1988', June, *Butterworths Journal of International Banking and Financial Law*, (1996), 255-258

[19] Basle Committee on Banking Supervision: *International Convergence of Capital Measurement and Capital Standards* (July 1988) *An internal model-based approach to market risk capital requirements* (April 1995). *Amendment to the Capital Accord to incorporate market risks* (January 1996). *Supervisory framework for the use of "back-testing" in conjunction with the internal models approach to market risk capital requirements* (January 1996). *The Capital Accord for the multilateral netting of forward value foreign exchange transactions* (April 1996). Basle, Bank for International Settlement; See generally, R Dale, 'Regulating Global Markets', Vol. 11, No. 9, *Butterworths Journal of International Banking and Financial Law*, (1996), 407-409. C M Friesen, et al, 'The 1998 Basle Committee Supervisory Initiatives and their Potential Consequences on International Banking Activities', Issue 2, *Journal of International Banking Law*, (1999) 55-61. L C Buchheit, 'A Lawyer's Perspective on the New International Financial Architecture', Issue 7, *Journal of International Banking Law*, (1999), 225-229. S Picciotto & J Haines, 'Regulating Global Financial Markets', Vol. 26, No. 3, *Journal of Law and Society*, (1999) 351-368

[20] Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Basle, Bank for International Settlement (1997). C Chatterjee, 'The Basle Core Principles for Effective Banking Supervision: an analysis', *European Financial Services Law*, February, (1999), 78-84

was a growing consensus that these standards are a part of international 'soft law'.[21] However, categorising such measures as 'hard' and 'soft' is questionable, because its principles are voluntarily accepted by responsible states. This was in many respects an evolutionary process, one in which global participation had been sought in devising standards acceptable to all.

The Basel standards of good practice are a recommendatory tool and encourage the endorsement of the Basle Core Principles. The chairperson of the regional supervisory groups noted a readiness on the part of members to promote the endorsement of the Core Principles.[22] Many of these standards have been further legitimatised by their incorporation into the jurisdictional/regional settings of banking-regulation and supervision, and have become part-and-parcel of IMF and World Bank reforms, thus ensuring that technical assistance in the context of an ever-increasing (allegedly) globalisation of finance is adequately regulated.[23]

The European programme for the completion of an internal market for financial services is very much in conformity with the Basel Committee, the catalyst being the 1985 White Paper for the Completion of the Internal Market.[24] The basis for the free movement of financial services is a system of co-ordinated, binding rules based on the notion of mutual-recognition of standards by Member States, provided that minimum standards comply with the provision of services and their establishment is recognised in the territory of the community. The primary basis of harmonisation is the principle of 'home country control,' although the host country is to have specific powers in the supervision of a credit institution based on the idea of 'the general good'.[25] Prudential controls will require adherence to the principles of management of

[21] L L C Lee, 'The Basle Accords as Soft Law: Strengthening International Banking Supervision', Vol. 39, No. 1, *Virginia Journal of International Law*, (1998), 1-40
[22] Basle Core Principles, (1997) op. cit., n. 20 at p. 3
[23] International Monetary Fund, *Financial System Soundness*, Washington DC, IMF, September (1999)
[24] Commission to the European Council, *Completing the Internal Market White Paper*, Brussels Commission to the European Council (1985) Com (85) 310 final; C Bradley, 'Competitive Deregulation of Financial Services Activity in Europe after 1992', Vol. 11, No. 4, *Oxford Journal of Legal Studies*, (1991) 545-558
[25] See specifically: M Gruson & W Nikowitz, 'The Reciprocity Requirement of the Second Banking Directive of the European Economic Community Revisited', Vol. 12, *Fordham International Law Journal*, (1989) 452-458; M Dakalias, 'The Second Banking Directive: The Issue of Reciprocity', *Legal Issues of European Integration*, (1991/2) 69-100; B Adkins, 'The Single Banking Market of the EEC: The Story So Far', Issue 6, *Journal of International Banking Law*, (1990) 251-257; A Haynes, 'European Regulation, and its Likely Impact on Banking and Securities Houses', Issue 5, *Journal of*

'own' funds, the solvency and liquidity ratio and the monitoring of large exposures. The basis for access to the market will also be controlled, with credit institutions bound to meet certain criteria before access is allowed.[26] The dual memberships of the majority of EU Member States, indicates that they and Basel have been working together: The European framework gives recognition to Basle's work in the continuing development of bank regulation and supervisory practices.

The International Organisation of Securities Commissions (IOSCO), an organisation consisting of securities regulators, has become an important player in the formation of financial regulation and supervision,[27] as a result of the growing involvement of banks in the securities markets, which requires greater co-operation between IOSCO and Basle. Its work has focused on the formulation of appropriate international guidelines to regulate financial conglomerates and capital-adequacy standards for both securities-houses and international banks. IOSCO maintains that its essential responsibility is to ensure the dismantlement of regulatory barriers, in particular, barriers to enforcement of national standards. The mainstay of these important non-governmental bodies is to ensure greater co-operation between states. The competitiveness of financial centres must be effective to attain similar standards between banks that are at different stages of sophistication in terms of risk study.

### 3.2 Authorisation - Banking Act 1987/FSMA 2000

The first facet of a 'command and control' strategy that needs to be considered is authorisation to undertake a particular type of business. Authorisation serves two main purposes: it attempts to eliminate incompetent players and to encourage depositors/investors to do business confidently. Authorisation acts as a simple yet effective mechanism for limiting access to a market and ensuring that the deposit-taking business is adequately provided for. Under the new regime, the FSA assesses authorisation in terms of potential risk to its regulatory objectives, such as market confidence and consumer interests.[28] An application for authorisation needs to

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*International Banking Law*, (1989) 215-219; K Lannoo, 'The Single Market in Banking: A First Assessment', Vol. 10, *Butterworths Journal of International Banking and Financial Law*, (1995), 485-490

[26] Commission White Paper, (1985) op. cit., n. 24, at para., 103-104

[27] M Taylor, 'The IOSCO Objectives and Principles of Securities Regulation', *Butterworths Journal of International Banking and Financial Law*, (1998), 326-331

[28] Auth 1.4

demonstrate compliance with an extensive range of prudential standards governing internal systems and controls.[29] The FSMA 2000 provides a single authorisation system for financial conglomerates with the permission to undertake regulated activities, whereas the 1987 Act authorised only those wishing to do deposit-taking business. However, the Bank (and now the FSA) attempted to ensure that banks authorised under the 1987 Act were allowed to participate in other forms of business.[30] The FSMA 2000, in keeping with the 1987 Act, prohibits unregulated activities by restricting the carrying-on of 'regulated activities' to those who are authorised or exempted,[31] and those who contravene the provision are subject to criminal sanctions.[32]

### 3.2.1 The meaning of 'deposit-taking business' and 'holding out to accept deposits'

The FSMA 2000 defines the meaning of `deposit' as did the 1987 Act. 'Deposit', on the face of it, is a range of possible transactions of which not all are 'banking business'. A distinction has been drawn between deposits and payment for services, this is pursuant to s.5(1)(a) of the 1987 Act which conformed with Slade LJ's decision in *SCF Finance v Masri*[33] in that margin-payments are payments deemed for the provision of services and not for deposit-taking business. The FSA takes a similar approach by focusing on an accepting of deposits which do not include advancements for goods and services, thus distinguishing 'deposits' from normal commercial transactions.[34]

According to the FSA, the activity of 'accepting deposits' needs to be done by way of business,[35] in a manner similar to that sanctioned by the 1987 Act, which referred to deposit-taking in the course of the business where money is received by way of deposit, then lent to others.[36] A literal interpretation could include many commercial activities that are not necessarily banking business. Subsequently, the FSA attempted to clarify the meaning of 'by way of business' by referring to the

[29] Ibid., 1.5, and 1.6, in particular, 1.6.9-12G
[30] See Chapter 1Evolution of Banking and Financial Regulation at p. 26
[31] FSMA 2000 Part II s. 19
[32] Ibid., s. 23
[33] *SCF Finance Co Ltd v Masri* [1987] QB 1007 at p.1020-1021
[34] Auth 2.6.2G
[35] Auth 2.3.1G

frequency with which deposits are accepted, which would normally be on a day-to-day basis rather than 'on particular occasions'. However, these guidelines provide limited clarification and the commercial nature of the activities needs to be assessed. This is supported by Slade LJ's definition of what amounts to a business activity, which complements the guidance provided by the FSA. That definition centres on the frequency with which a person holds himself out to receive deposits, by way of express or implicit request, on any normal working day, and upon acceptance by the person invited to deposit:

> "... *'a person' holds himself out to accept deposits on a day to day basis only if (by way of an express or implicit invitation) he holds himself out as generally willing on any normal working day to accept such deposits from those persons to whom the invitation is addressed who may wish to place monies with him by way of deposit ... the mere fact that these occasions may be numerous does not render them any less 'particular'.*"[37]

### 3.2.2 Authorisation and Permission

The FSMA 2000 introduces another cog into the authorisation machine: 'permission'[38] to carry on regulated activities. This is simply another label for 'authorisation to carry on a regulated business'. The application for Part IV permission requires the applicant to satisfy 'threshold conditions' on a continuing basis.[39] These threshold conditions are the same as those of Schedule 3, Minimum Criteria for Authorisation, of the 1987 Act. The powers of the FSA here are broad and include the authority to change permission-status if it thinks that the regulatory objective of consumer protection is imperilled. This allows the FSA extensive scope for exercising its decisions about authorisation. The FSMA 2000 requires also that the regulated activities be identified so that the FSA can incorporate limitations or include requirements it thinks appropriate for controlling the way the regulated activities are performed. These powers are similar to the directions the FSA was entitled to issue under the authority of the 1987 Act, such as requiring an institution to take certain steps to pursue a particular course of action; imposing limitations on the acceptance of deposits, grant credits or investments; prohibiting certain classes of transaction.

[36] 1987 Act s. 6(1)
[37] *SCF Finance* [1987] op. cit., n. 33, at p. 1022-1023
[38] FSMA 2000 s. 40

The FSMA 2000 gives the FSA the powers to control entry and exist, whether voluntarily or by coercion, in the financial markets. Under the new regime, once a Part IV permission is granted, a deposit-taking institution that wishes to change the permission that governs its regulated activities can make a request to the FSA for a change that either adds to, removes or cancels that permission. In its exercise of this power, the FSA has to consider whether or not the proposed change will adversely affect the interests of consumers and potential consumers. The FSA has the authority also to vary a Part IV permission on its own initiative if, for example, the authorised person fails or is likely to fail to meet the threshold conditions, or it is desirable to vary the permission to protect the interests of consumers and potential consumers. These powers are deemed 'own-initiative power', and are a formal recognition of the informal judgement-based approach characteristic of financial regulation, particularly in the banking industry.[40] The FSA can impose, vary, or remove requirements relating to 'acquiring control'.[41]

Under the FSMA 2000 the following are deemed authorised: a person with a Part IV permission; an EEA firm; a Treaty firm; and a person authorised in some other way under the FSMA 2000.

### 3.2.3 European Authorised Institutions under the Second Banking Directive

European credit institutions that are incorporated in or formed under the law of another Member State are exempt from the FSMA 2000.[42] The Second Banking Directive (SBD), as explained above, has a single system of authorisation for EEA-designated institutions within the Member States. The SBD provides a standardisation of minimum capital-requirements, regulations to ensure sound and prudent management of the ownership and acquisition of credit institutions, and abolishes the right to request endowment-capital for new branches.

[39] Ibid., s. 41

[40] Ibid., s. 45

[41] Ibid., s. 45-48

[42] SI, 1992 No. 3218 Banks and Banking *The Banking Coodination (Second Council Directive) Regulations 1992* Part II Recognition of European Institutions: Reg., 3(2):

> "A credit institution is a European authorised institution if: (a) it is incorporated under the laws of another member State; (b) its principal place of business is in that State; or (c) it is for the time being authorised to act as a credit institution by the relevant authorities in the member State."

The SBD allows credit institutions authorised in a home Member State to carry on any of the listed activities[43] it is authorised to undertake as a credit institution, provided the credit institution is authorised to carry on such business in the home Member State. A credit institution is required to notify the home Member State and host Member State of its intention to establish a branch and/or provide services listed in Schedule1 of the Instrument.[44] The notification must include information regarding the location and administration of the branch, and a break-down of the activities proposed. The home Member State has to provide details of its 'own funds' and solvency-ratio to the host Member State. Under Schedule 2 para., 4, the credit institution's branch is required to notify the home and host State of changes to functions it requested in the home state. The host Member State is required to prepare for the supervision of credit institutions by drawing to an institution's attention the regulations governing credit institutions.[45] The host authority retains the power to prohibit[46] the acceptance of deposits and restrict[47] a credit institution's right to undertake the listed activities with reference to the Instrument. The host Member State can allow the institution to remedy the situation, but if the institution fails to

[43] Ibid., Schedule 1: List of Activities Subject to Mutual Recognition:
1. Acceptance of deposits and other repayable funds from the public;
2. Lending(1);
3. Finance leasing;
4. Money transmission services;
5. Issuing and administering means of payment (e.g., credit cards, travellers' cheques and bankers drafts);
6. Guarantees and commitments;
7. Trading for own account or for account of customers in:
    a) money market instruments (cheques, bills, CD's etc);
    b) foreign exchange;
    c) financial futures and options;
    d) exchange and interest rate instruments;
    e) transferable securities;
8. Participation in share issues and the provision of services related to such issues;
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings;
10. Money broking;
11. Portfolio management and advice;
12. Safekeeping and administration of securities;
13. Credit reference services;
14. Safe custody services.

(1)consumer credit
mortgage credit
factoring, with or without recourse
financing of commercial transactions (including forfaiting)

[44] Ibid., Reg., 6 Procedural requirements for carrying on listed activities
[45] Ibid., Reg., 8 Functions of Bank, Duty to prepare for supervision
[46] Ibid., Reg., 9 Power to prohibit the acceptance of deposits
[47] Ibid., Reg., 10 Power to restrict listed activities

comply, then the host Member State will notify the home Member-State authority so that it can take the appropriate measures to ensure compliance. The FSA requires the home Member State authority to furnish appropriate information. Only if the competent authority in the home Member State fails to do that can it take what it deems to be appropriate steps. However, in emergencies, the host Member State can override these measures to ensure home Member State control, in order to safeguard its interests, though it must notify the home Member State at the earliest opportunity.[48]

### 3.2.4 Non-European Institutions under the Second Banking Directive

The UK financial markets have traditionally been characterised as 'open' in terms of providing unrestricted access to the UK capital markets. However, with the introduction of the SBD and the single-passport regime, new arrangements were put in place to ensure reciprocal market-access and the treatment for EU-designated credit institutions.[49] This development was one of the most contentious in the City of London Markets because of its international character. Its consequence was that the UK could no longer negotiate on a bi-lateral basis for reciprocal market-access or for national treatment of its incorporated authorised institutions. Non-EU credit institutions, therefore, would find their access to the European Single Market restricted to a branch, and they might be prevented from taking advantage of the single-passport facility. According to the Title III Relations with Third Countries, the competent authority is required to inform the European Commission of any direct or indirect request for authorisation to its capital markets. The purpose of this provision is to ensure that European credit institutions are given market-access and treatment similar to that provided to Third-country institutions in the EU single market. This places the Commission in a very strong position because it gives it the discretion to determine whether a non-EU country provides effective market-access and national treatment to all EU member-states. This prevents bi-lateral negotiation between an individual EU member-state and a Third Country. However, the wider concern about this policy is that it does not link 'reciprocal access' and 'economic development and

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[48] Ibid., Reg., 11

[49] C Chatterjee, 'The EC Second Banking Directive: Relations with Third Countries', Vol. 10 No. 12, *Journal of International Banking Law*, (1995), 511-516; H S Scott, 'Reciprocity and the Second Banking Directive' in R Cranston, (ed.), *The Single Market and the Law of Banking*, London, Lloyds of London Press (1991) 85-91; M Dokalias, 'The Second Banking Directive: The Issue of Reciprocity', *Legal Issues of European Integration*, (191/2); and J Story and I Walter, *Political*

sophistication of financial markets'. Rather, it provides simply for sovereign equality in law, unmindful of the fact that less-developed Third countries may not have the capacity to confer the stipulated 'similar' market-access and national treatment of EU credit-institutions that EU member-countries can confer.

### 3.3 Supervision and Risk

The purpose of supervision is to manage and control risk, and the methods of minimising risk are in its system of authorisation and the further-risk minimising process. This system of supervision has two aspects: 'command' and 'control'. Control by supervision can be coercive in nature, with external and internal audit[50] and general-through-capital adequacy and solvency-ratio.

A more sophisticated form of 'command and control' has evolved with the introduction of the 'risk-based approach', which attempts to be more pro-active in regulatory decision-making and less retro-active on the basis of historical data of past events. This is particularly important when the risk-profile of a bank has changed considerably, especially with increasing exposure to market-risks (as distinct from credit risks) which can change rapidly. This has brought to the fore the increased use of risk-management techniques and financial instruments to manage risk and has placed greater emphasis on management-responsibility and internal controls.[51] The introduction of the risk-based approach means that financial conglomerates that take several types of risk can be more effectively supervised now than before, because this approach is focused on risk varieties, not only on the traditional credit-risk types.

The risk-based approach to supervision — Risk Assessment Tools Evaluation (RATE)[52] and Schedule 3 Compliance Assessment, Liaison and Evaluation (SCALE)[53] — was implemented after the review of banking supervision and surveillance that was occasioned by the Barings collapse. According to the Andersen

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*economy of financial Integration in Europe: The Battle of the Systems*, Manchester, Manchester University Press (1997) at p. 285-291

50 See Chapter 6 The Role of Auditors and Reporting Accountants at p. 205

51 See Chapter 4 Corporate Governance and Banking Supervision at p. 118

52 Bank of England Supervision and Surveillance, *A Risk Based Approach to Supervision (the RATE framework)*, London, Bank of England March (1997)

53 Bank of England Supervision and Surveillance, *A Risk Based Approach to Supervision of Non-EEA Banks (the SCALE framework), A consultative paper by the Bank of England*, London, Bank of England July (1997)

Report,[54] the supervisory approach of the *pre*-Barings period was made up of various methods, among which the SWOT analysis was notable, for assessing the strengths and weaknesses of banks. Those methods did not provide an effective and systematic decision-making mechanism. The implication of the introduction of new methods was that the extant ones had been condemned as a fragmented approach to the assessment of banks,[55] and that a more systematic approach was deemed necessary for determining banks' risk exposure.

The FSA's risk-based approach is necessary to ensure that the authorised are complying with the prudential measures introduced by the FSMA 2000 for the purpose of ensuring confidence in the markets and for protecting consumers.[56] This risk-based approach built on existing tools of supervision instead of radically overhauling them. It includes review of prudential returns, on-site visits, use of skilled persons and meetings with management.[57] The risk-assessment process provides the information on the basis of which formal requests for remedial changes to the institution can be made, and it emphasises the consequence of non-compliance. The risk-based approach is said to enhance the efficiency and effectiveness of supervision for both the regulated and regulator because it allows both parties to focus attention on areas of greatest risk.[58] Emphasis is now on how much those risks threaten the FSA's attainment of its regulatory objectives. The size of the threat determines the intensity of the supervision. The effectiveness of the risk-based approach has not been assessed in the UK because it became operational only recently.[59]

The US introduced a risk-based approach after the 'savings and loans' debacle of the late eighties and nineties.[60] The risk-based approach is applied to the

[54] Arthur Andersen, *Findings and recommendations of the review of Supervision and Surveillance*, London, Arthur Andersen & Co 24th July (1996) at para, 38-52 p.7-9. (Arthur Andersen Report). This was endorsed by the Bank and incorporated into the supervision of banks. Bank of England, *The Objectives, Standards and Processes of Banking Supervision*, London, Bank of England (1997)
[55] Ibid., at para, 39.
[56] SUP 1.1.2G
[57] SUP 1.4
[58] SUP 1.3.1G. Building on the previous approach see, Financial Services Authority, *Risk-based approach to supervision of banks*, London, Financial Services Authority June (1998)
[59] Bank of England, Banking Act Report 1997/98
[60] General Accounting Office, *Bank and Thrift Examinations: Adoption of Risk-Focused Examination Strategies*, Washington DC, United States General Accounting Office October (1998) GAO/t-GGD-98-13. According to this report, over the 80's and 90's the US Federal Deposit Insurance Fund experienced record pay outs as a result of the losses incurred by the thrift and banking institutions.

supervision of large complex institutions (financial conglomerates).[61] The regulatory bodies responsible for supervision have developed their own style of risk-focused supervision, so where there is more than one regulator there is always a need to make provisions for consistency and for avoiding overlap. A single regulator, sensitive to the idiosyncratic nature of the various types of business in conglomerates, is likely to be more efficient. Since the FSA is established and because it has collected the regulators under the umbrella of the FSMA 2000, these problems may not manifest in the UK.

The traditional method of supervision coupled with the risk-based approach still has its limitations[62] because it continues to rely on trust, honesty and the co-operation of authorised institution and persons. However, no form of regulatory strategy can eradicate all fraud, but greater emphasis on management responsibilities and internal controls can produce an increase in detection. The risk-based approach poses a particular concern that regulatory attention is focused primarily on areas that cause the greatest risk at the expense of the parts of a business deemed to be low risk. The GAO contends that the success of a risk-based approach is very much dependent upon the expertise of supervisors in identifying potential risks.[63]For example, after the Barings collapse, the Arthur Andersen Report noted a lack of specialised resources at the Bank to monitor securities risk[64] this led to the establishment of a Market Risk Team.

The setting up of a complex group-division within the FSA means that a greater variety of technical resources are available for more effective risk-based supervision. Moreover, the basis for advocating the risk-based approach demands that a pro-active supervisory regime is in place and is almost the same as an enforcement regime. However, regulators still face the problem that an unexpected turn in an

This resulted in the failure of 1,300 thrifts and 1,617 federally insured banks which were closed or received some form of assistance. The total losses experienced by the deposit insurance fund totalled $125 billion. at p. 4. For an examination of risk-based approach for foreign US banks see: G M Welsh, 'The New Supervisory Regime for Foreign Banks in the US: The ROCA, Combined and SOSA Rating Systems', Vol. No. 6, *Butterworths Journal of International Banking and Finance Law*, (1995) 267-271

[61] GAO, *Risk-focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, Washington DC, United States General Accounting Office January (2000)

[62] Ibid., at p. 40

[63] Ibid., at p. 40

[64] Arthur Andersen (1996) op. cit., n. 54, at para., 146

economy can make particular types of risk more onerous in terms of the stability of a bank.

The ability of the regulator to identify risks is also crucial. For example, regulators did not fully assess the risks posed by Long Term Capital Management (LTCM).[65] Too much reliance on the management and information system of the regulated also leads to over-reliance on the information and data generated by the risk-management systems, resulting in possible underestimation of the risks to the counter-party or market risks by the institution. This can be exacerbated when the regulator is assessing internal models devised and utilised by an authorised institution. According to the GAO Report, such models require individual attention because they are devised to delineate the risk-parameters of an institution rather than to assist regulators.[66] Whether the management systems of an authorised institution are centralised or decentralised is also an issue. It is necessary for a decentralised management-system to adopt a consolidated risk-based approach because that draws out the inherent limitations that could adversely affect the parent company. In situations where there are multiple authorisations across jurisdictions and business lines, an individualised programme of examination is crucial, but this requires a large regulatory resource. One of the reasons why Barings failed was the lack of effective management-controls in its worldwide activities, particularly in its Futures (Singapore) arm. The resultant difficulty with the matrix-management system led to confusion about who should receive reports relating to its 'switching business'. This and other failures such as Daiwa's has led to greater co-operation between regulators in various jurisdictions, even though, in the case of Daiwa, co-operation from the Japanese Ministry of Finance was not forthcoming.[67] A Memoranda of Understanding was concluded by the various US regulators, the Bank of England and the FSA to deal with the sharing of information on internal controls and risk management systems regarding 'Designated Relevant Firms'.[68]

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[65] GAO, *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, Washington DC, United States General Accounting Office October (1999) GAO/GGD-00-3

[66] GAO, *Risk Based Capital: Regulatory and Industry Approaches to Capital and Risk*, Washington DC, General Accounting Office July (1998) GAO/GGD-98-153 at p. 92

[67] 'Why Daiwa had to quit the USA', *Central Banking* (1995)

[68] 'Memorandum of Understanding' between the SEC, CFTC, Bank of England and FSA. 27th September (1997)

### 3.3.1 FSA Principles for Business

Institutions permitted to undertake regulated activities are required to comply with the principles that govern their businesses: Those authorised to accept deposits are governed by the principles that seek to ensure prudence, and ultimately, confidence in the financial system.[69] Those principles cover a broad spectrum of issues, from the way the business is done to the way the authorised institution co-operates with the FSA.[70] The principles are vague but are given substance by the underlying threshold-conditions and prudential requirements necessary to carry on the business of accepting deposits. Some of the principles, such as 'a firm must conduct its business with due skill, care and diligence', are well established in statutory law.[71] They do, therefore, have a high degree of legal certainty, which serves to undermine the argument that they are challengeable under the Human Rights Act 1998.

### 3.4 Solo and Consolidated Supervision

Solo supervision consists of evaluation of the strengths, weaknesses and risk-levels within a group that could affect the bank. The FSMA 2000 provides minimum criteria for granting permission to carry out regulated activities. These are the 'threshold conditions'.[72] The term 'threshold' suggests that these requirements need to be met at the beginning, or at the point of entry, although the actual requirement is

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[69] FSA, Principles of Business, posted at: http:/ www.fsa.gov.uk/handbook/prin.pdf ,at PRIN 1.1.3G

[70] Ibid., PRIN 2.1.1R Principles:

1. Integrity: A Firm must conduct its business with integrity.
2. Skill, care and diligence: A firm must conduct its business with due skill, care and diligence.
3. Management and Control: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial Prudence: A firm must maintain adequate financial resources.
5. Market Conduct: A firm must observe proper standards of market conduct.
6. Consumers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and another client.
9. Customers: relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. Clients' assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Regulations with regulators: A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

[71] See generally, Chapter 4 Corporate Governance and Banking Supervision

[72] FSMA 2000 Schedule 6 includes: legal status, location of offices, close links, adequate resources and suitability. See for guidance COND 1

'continuous' in the sense similar to that of s.9(2) of the 1987 Act, which required the satisfaction of Schedule 3 before authorisation is granted.

In order to retain authorisation under the 1987 Act, the bank had to comply with Schedule 3 of the 1987 Act and the provisions relating to capital-adequacy, liquidity and the 'fit and proper' rules concerning directors, management and controllers. The 'threshold conditions', in contrast to Schedule 3 of the 1987 Act, place some of the prudential measures, which were originally a part of prudential guidance, on a statutory footing. In the standards provided by Schedule 3 of the 1987 Act and the by FSMA 2000, 'threshold conditions' are rudimentary and to a large degree discretionary in their application. These broad standards outline the level of care required to ensure compliance, and therefore require continuous adjustment of their precision to enable prudential supervision to meet the various movements in the industry.[73] Consequently, further rules and guidance are provided by s.138 of the FSMA 2000, which mirror, in many respects, the previous prudential requirements governed by the 1987 Act.[74]

The first threshold-condition[75] to be met for the granting of permission is the requirement that the legal status of the entity seeking to authorise a person to accept deposits must be either a body corporate or a partnership. In the case of partnerships, the 1987 Act added that authorisation would not be granted a partnership if its assets are in the name of just one partner.[76] Possibly, this is in place to ensure that there is compliance with the four-eyes principle of having two individuals in control. The second threshold[77] is the requirement that the head office and registered office both be located in the UK. This fulfils the *post*-BCCI directive to reduce the likelihood of another BCCI. Its centre for management in London, but its place of incorporation was Luxembourg that prevented effective supervision of its operations.[78] The third threshold[79] incorporates another requirement of the *post*-BCCI directive: that

[73] See Chapter 1 Evolution of Banking and Financial Services Regulation
[74] FSA, Interim Prudential Sourcebook: Banks (IPRU (Bank)) posted at http://www.fsa.gov.uk/handbook/sup.pdf
[75] COND 2.1
[76] 1987 Act s. 9(5)-(6) 1987 Act
[77] COND 2.2
[78] United Kingdom Administrative Arrangements for the Implementation of the Close Links Provision of the Post - BCCI Directive (No: S&S/1996/9)
[79] Ibid., reg. 2.3

authorised persons must disclose links with other persons so that the FSA can identify the location of possible risks to the authorised person. The FSA has the right to seek information about any close link it wishes to know about, even in cases where the close link is an exempted entity. The FSA can individually discuss its requirements of notification about close links, especially in the case of non-EEA incorporated credit-institutions. The close links' materiality will be assessed, as will changes in links within the banking group. The fourth threshold[80] requires that the authorised person have adequate resources for regulated activities on a solo and consolidated basis, including provisions for future and contingent liabilities. The authorised person must, as part of a group, manage risks in connection with its business. Extensive guidance is provided to supplement these conditions.[81]

The FSA have adopted a rules-based approach to the supervision of banks. This is clear even in the interim prudential source-book which is replaced by a more elaborate integrated source-book for regulated activities. The prudential rules governing bank activities are further complicated by the adoption of Principles of Business[82] and Statements of Principle for Approved Persons,[83] which over- elaborate the simple principles of prudence devised by the previous regime. However, it can be argued that providing this level of rules and guidance reduces the level of uncertainty in the minds of the regulated and the regulator about the purpose (which is to safeguard consumers and market confidence) of prudential rules.[84] The following sections attempt to examine some of the core principles of prudential supervision.

### 3.4.1 Consolidated Supervision

The safety and soundness of banks has obliged authorised institutions to comply with particular prudential regulation and supervision, which has historically focused on domestic business. Again, in the light of the experience of early 'seventies banking, regulators recognised the effect of business operations in host countries on the home country, and vice-versa. This required them to focus on areas beyond the home market and to pay attention to the transnational operations in host countries

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[80] Ibid., reg. 2.4
[81] IPRU (Bank) op. cit., n. 74 at GN: S. 2
[82] PRIN op. cit n. 69
[83] FSA, Statements of Principles and Code of Practice for Approved Persons, posted at: http://www.fsa.gov.uk/handbook/aper.pdf

(whether they be branches, subsidiaries or joint ventures) and to include these operations in what is called 'consolidated supervision'. The general principle which underpins the Basle rules is that no banking institution can avoid supervision. The importance of consolidated supervision has, like other regulatory measures, developed as a reactive measure to reduce the likelihood of banking failures or collapses that cause systemic collapse or risk of contagion of host and home markets. Prominent failures such as Franklin National Bank, Banco Ambrosiano, BCCI, Barings and others have created a need for consolidated supervision. Consolidated supervision has evolved, with the work of Basle and with the European Community programme for the completion of the single market, into a framework of broad principles and rules. Due to the nature of both forms of rules, the regulator is left with the responsibility of interpretation, which can result in different applications of the rules.

Basle rules have evolved through 'Accords', or broad measures of negotiated statement-of-intent. The responsibilities of the home and host countries are derived from the reciprocal rights and powers for limiting fall-out from the collapse or failure of a bank that affects each.[85] This is to ensure that host states are not exposed to regulatory failures in home states. The EC directive on consolidated supervision places emphasis on the need for the home regulator to effectively supervise operations based on 'mutual recognition', in accordance with which the host state has no power for revoking or restricting authorisation granted under the SBD, unless those things are done in the interest of a 'general good' such as the deflection of a systemic crisis.

This is notwithstanding that under both regimes greater responsibility for prudential supervision is placed on the home state. The Basle Accord 1992 takes a pragmatic approach in that it allows a host country to impose restrictions that satisfy its prudential concerns, or to prohibit an establishment all together, if the home country is not fulfilling its responsibilities to its satisfaction.[86] This is supplemented

[84] IPRU (Bank) op. cit., n. 74, at GN: S. 2 (3)-(4)
[85] Basle Principles for the Supervision of Banks' Foreign Establishments (May 1983)
[86] Basle, Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments (July 1992)

with the recognition of the importance of co-operating with offshore bank supervisors to reduce the likelihood of another Barings-style collapse.[87]

Basle Core Principles recommend that bank supervisors practise global consolidation of internationally active banks by applying 'appropriate' prudential measures to 'all aspects' of their business.[88] The Core Principles also make it mandatory that bank supervisors 'require the local operations of foreign banks to be conducted to the same high standards that are required of domestic institutions', thus advocating peer-review to ensure an open gateways for exchanging information.[89]

The Second Consolidated Supervision Directive (SCSD) introduced the necessity for consolidated supervision of all banking groups, in particular, parent undertakings that are not credit institutions.[90] The SCSD provided consolidated supervision of credit institutions whose business includes activities listed in the Annex to the Second Banking Directive (SBD).[91] The consolidated supervision of market-risk is co-ordinated so that risks of credit institutions and securities firms can be estimated on similar terms, which provides a 'level playing field' in terms of the capital required to pursue a securities business.[92]

In an assessment of the strength of the bank within a group, the capital resources of the bank and of the group are the key foci of consolidated supervision. The assessment is made in the context of the business conducted, the level of diversification within the group, and the experience of management. This amounts to an assessment of the internal system, and its objective is to ensure that the procedures of risks-management are safe.[93] Under both Basle and the EC, the home country takes responsibility for prudential supervision, co-operation with the host state, and the supervision of capital-adequacy, solvency and liquidity. This is particularly important in branches deemed to be part of a parent institution. However, for subsidiaries the

[87] Basle Committee on Banking Supervision, Cross-Border Banking, Report by a Group comprised of Members of the Basle Committee and the Offshore Group of Banking Supervisors, October 1996
[88] Basle Core Principles (1997) op. cit., n. 20 at Rec. 23
[89] Ibid., at Rec. 25
[90] Second Council Directive 92/30/EEC of 6th April 1992 on the supervision of credit institutions on a consolidated basis. at Art. 3
[91] Ibid., recital 7
[92] Ibid., recital 8
[93] Ibid., Article 3(5), (6) and (7)

situation can become more problematic.[94] Under the Basle rules, prudential supervision is a joint responsibility. For the purpose of consolidated supervision, the home state is required to assess the solvency of the foreign establishment, and the host state to assess its solvency and liquidity – because it is technically a separate legal entity.

The FSA undertakes consolidated supervision of UK-incorporated banks in order to ensure that the authorised institution has 'adequate resources' and is 'suitable'.[95] It is the intention of the FSA, as it was the Bank's, to extend consolidated supervision beyond the scope stipulated in the second directive, and it is done in accordance with its responsibilities under the Capital Adequacy (CAD) regime.[96] The FSA has responsibility for conducting the consolidated supervision of banks when they are the members of wider groups, its main concern being the interests of banks. The FSA undertakes consolidated supervision in addition to solo supervision of authorised institution, in particular, the transactions done on behalf of other components of the group.[97] Consolidated supervision is not deemed a substitute for solo supervision.[98] It conducts a qualitative assessment of risk-capacity (estimated in RATE terms-of-reference) and is based upon a quantitative assessment that determines the size of the consolidated capital that the bank is required to maintain.[99] The FSA applies a different consolidated-supervision regime, to banks deemed to be 'CAD banks'.[100] This consolidated approach for determining capital requirements relies on a banking-and-trading book-regime rather than on the strategies of solo supervision. In the book-regime the non-trading activities and assets of a financial company other than an investment firm are recorded on a line-by-line basis.

### 3.4.2 The Limits of Consolidated Supervision

Consolidated supervision requires close monitoring of activities on a trans-national basis. It is somewhat limited because it relies on general understanding. Solo

[94] Ibid., Article 5
[95] IPRU, CS: S. 1 at p. 1-2
[96] Ibid., CS: S. 1(4) at p. 1
[97] Ibid., CS: S. 4 at p. 1-4
[98] Ibid., CS: S. 8 at p. 1-6
[99] Ibid., CS: S. 3 at p. 1-3
[100] Ibid., CS: S. 6: Page 1-6

supervision, conducted by specialised regulators, provides a much more comprehensive understanding of the risks in an institution.

The Bank developed considerable experience in co-operating with other regulators, such as security regulators, particularly after London's Big Bang, when it took on a lead role as regulator of banks' securities business, particularly in the area of capital-adequacy. The Bank's policy of consolidated supervision and large exposures was applied also to the non-bank financial activities in which authorised institutions are involved.[101] The changes in the method of supervision after the Barings collapse are, in many respects, due to the growing involvement of banks in the securities business. The lessons drawn from the collapse raised the Bank's awareness of the need to improve its understanding of non-bank business.[102] Equally important was management-control of the risks which stem from such business, so that the Bank could 'determine which companies within those groups, or which activities of such companies, are so significant that problems with respect to them might reasonably be expected to pose difficulties for the bank'.[103]

According to the Barings Report, control of risk can be effective where there is a large scale of co-operation among regulators. Co-operation between regulators is not necessarily new but is in fact a central plank of supervision, particularly where a large proportion of a financial institution is foreign. The required level of co-operation is in many respects essential for the effective supervision of foreign banks in the UK: It is far more important now because of the inter-dependency of financial markets and participation of banks in diverse markets. No one industry-regulator can effectively control the activities of financial conglomerates that are internationally active in the various financial services.

The basis for co-ordinating the activities of regulators, whether they be cross-border or cross-sector, is the Memoranda of Understanding (MoU). This is a

[101] See also Basle Committee on Banking Supervision. Exchange of Information between Banking and Securities Supervisors (April 1997)
[102] J J Norton & C D Olive, 'Globalization of Financial Risks and Securities Firms: Lessons from the Barings Debacle', Vol.30, No.2, *International Lawyer*, (1996) 301-345. G Adams, 'The Regulation of financial conglomerates', Vol.5, No.3, *Journal of Financial Regulation and Compliance*, (1997), 215-221

memorandum of intent signed by the regulators rather than an agreement between states. The MoUs are essentially concerned with exchange of information or guidelines for co-operation between regulators in particular circumstances.[104] In the MoUs exchanged by the Self Regulatory Organisations and the Bank, would take principal responsibility for the supervision of the capital-adequacy of a group and the financial soundness of its bank. (In this context, 'the group' consists of regulated entities obliged in strict terms to abide by their particular capital-adequacy and other prudential requirements). A number of MoUs, adapted to take into account the changing risk and information requirements, have fluttered between cross-sector and cross-border regulators in an effort to effectively supervise the activities of bank financial-conglomerates across the board.

The heightened internationalisation of financial participants clearly requires effective co-operation, without which the home or host regulatory control can only be limited. This was particularly obvious in the BCCI and Barings collapses[105] and on other occasions where co-operation was simply not forthcoming, such as in the German regulators' communications with the international creditors of Bankhaus Herstatt.[106] In the case of BCCI, the over-reliance on the Luxembourg Authorities under s3(5) of the Banking Act 1979 contributed to continuing authorisation, even though the Luxembourg authorities had notified the Bank that they could not supervise BCCI and its activities effectively.[107] International co-operation is given a statutory platform by s.9 (3) of the Banking Act 1987, which allowed the Bank (FSA) the option of relying upon the judgement of the home-regulator of the country in which a business is predominantly situated. This was done to enable applicants for authorisation under the Act (directors, *etc.*) to comply with the 'fit and proper

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[103] The Report of the Board of Banking Supervision Inquiry into the circumstances of the collapse of Barings, London, HMSO 18th July (1995) at p. 257

[104] IMF, *International Capital Markets: Developments, Prospects, and Policy Issues*, Washington DC, International Monetary Fund (1996) at p. 150

[105] The Board of Banking Supervision's Report. Highlighted that particular lessons could be drawn from the Barings Collapse, particular in the area of liaison with other regulators. "However, we note that the existence of regular and open contact between regulators internationally, in order to assist them in the discharge of their respective responsibilities through such measures as the exchange of information, is desirable and is to encouraged." Op. cit., n. 100, at p. 259, para., 14.45

[106] E Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990's*, Ithaca New York, Cornell University Press (1994) p. 171-173

[107] See Report, Inquiry into the Supervision of the Bank of Credit and Commerce International, The Right Honourable Lord Justice Bingham, 27th July 1992. *Three Rivers DC and Other & BCCI v. The*

persons' provision of paragraph (1), the 'business to be conducted in prudent manner' provision of paragraphs (4) and (5), and the 'integrity and skill' provision of Schedule 3.

The continuation of BCCI's operations despite its damaged credibility was possible because it was able to retain the status of being a body under the supervision of the College of Regulators while the Bank was straining to find a way of safeguarding the interests of depositors and potential depositors. This shows that if co-operation with a regulator is not fulsome, fraud and other malpractice can flourish to the point where a financial institution becomes a liability in an economy. A key recommendation of the Bingham Report is the effective sharing of information, a recommendation that Basel continued to develop.[108]

It is important, particularly for Third-Country regulators, that regulators are able to verify information about applicants with their own assessments of those applicants. Information is crucial for an adequate supervision of activities and for an understanding of their risk-exposure. The issue of co-operation between bank and securities regulators is not new: Under the terms of the Second Banking Directive, the Bank had to provide access and information in the matter of European Authorised Firms, an obligation modified only by the provisions of the 'general good' exception, which are based on the assumption that European Authorised Firms are regulated in accordance with the minimum criteria. The Second Banking Directive also makes provision for the exchange of information between banking and securities regulators. It is essential for regulators to be satisfied with the level of control of banking and non-banking activities, for both can impact upon depositors.

In the wider context, Basel provided some clarity with its 1990 paper.[109] The proposals in the Basel Paper were arguably undermined by the Barings collapse, although in that situation a number of its proposals were not heeded by either set of regulators. The Bank in particular should have had a much clearer understanding of

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*Governor and the Company of the Bank of England*, High Court of Justice Queens Bench Division July 30 1997 1993 Folio No. 1309

[108] Basle, *The Compendium of Documents Produced by the Basle Committee on Banking Supervision: Volume Three International Supervisory Issues*, Basle Bank for International Settlement, April 1997.

[109] Basle: Exchange of Information between Banking and Securities Supervisors (April 1992)

Barings' operations in the Far East and the levels of control the London Office had over its operations. The fact that it did not, betrays over-reliance on Barings itself, the Bank's lack of communication with the Singapore Authorities, and vice versa. The Barings collapse highlighted the reluctance of regulators to co-operate[110] with the investigations that were undertaken, which was contrary to the spirit of the Basel Paper and its emphasis on the importance of information-exchange between banking and securities regulators. This tends to confirm the view that a strict delineation of the nature of 'reciprocity between regulators' 'would prevent any information being exchanged' and that a wider interpretation was needed for information to flow freely. Simply, reciprocity needs to be fairly liberal.[111] While countries do recognise the importance of co-operation, they are reluctant to undermine the trading interests of persons under their jurisdiction. This problem is highlighted by the implementation of the Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters 1970,[112] which has resulted in many jurisdictions introducing 'blocking statutes' to prevent 'fishing expeditions' or the transfer of information that is not in the public interest. For example, the UK introduced the Protection of Trading Interests Act 1980 in order to curb the extraterritorial reach of laws emanating from another jurisdiction.[113]

The reciprocity between the Bank's Board of Banking Supervision and the Singapore Authorities was a key issue in the relevant jurisdictions' investigations. Requests for information had to be given adequate consideration. According to the Singapore Report, the initial request for interviews by the Singapore Authorities was rejected by the HM Treasury because it was 'of the view that there was no reciprocity in connection with the Board's work in Singapore'. This decision was reversed

[110] According to First Report of the Treasury Committee. "Since the collapse of Barings regulators have recognised that insufficient emphasis had been placed on contacts at an international level. Sir Andrew Large commented in a recent speech that securities regulators in particular had tended in the past, to be "somewhat domestic, preoccupied with individual firms often on a solo basis." This is something which Mr Nicholas Durlacher, Chairman of the SFA. "[W]here a firm is part of a group, even if it is subject to consolidated oversight by another regulator, we should nevertheless not confine our attention purely to that firm; ... we should ensure that we and other regulators involved (the Bank of England in particular) fully understood each other's approach and assumptions about what each were doing." at p. xiii-xix

[111] Basle, (1992) op. cit., n. 109, at p. 56

[112] Ph W Amram, *Explanatory Report to the Hague Convention 1970*, The Hague, Martinus Nijhoff (1986)

later.[114] The formal requests through the courts were unsuccessful because no benefit accrued to the Judicial Managers intervening in the co-operation of ING. The Board and the Singapore authorities did, however, arrange an informal exchange of notes between the investigating teams. This was deemed adequate consideration.[115] On a wider note, the Barings debacle called into question the role of external auditors. This was investigated by the UK Accountancy Profession; however, the Singapore Authorities refused to co-operate.[116]

Both these episodes highlight the reluctance of governments and regulatory authorities to co-operate in such matters, especially when damage has already occurred. Central to the unwillingness to co-operate is a desire not to undermine the interests of those in one's own jurisdiction by a 'reciprocation of the parties' involving banking, securities and other financial regulators. The reciprocal needs of regulators inevitably differ because each will attempt to safeguard parties with specific interests and to safeguard national interests. Therefore, the interests of depositors could conflict with those of securities regulators whose interests are vested in the integrity of the market and allied with on-exchange participants' interests.

The Barings episode was merely another warning to the international community to develop further agreements about co-operation for sharing information, in particular, between the regulatory bodies responsible for the various types of business, and thereby build on the work of Basel. The Joint Statement at Lyon by Basel and IOSCO identified eight principles that members should promote:

- "Co-operation and information flows among supervisory authorities should be as free as possible from impediments both nationally and internationally;

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[113] L Collin, 'Blocking and Clawback Statutes: The United Kingdom Approach-I', *Journal of Business Law* (1986) 372-377; L Collin, 'Blocking and Clawback Statutes: The United Kingdom Approach-II', *Journal of Business Law* (1986) 452-465

[114] Barings Futures (Singapore) Pte Ltd Investigation pursuant to Section 231 of the Companies Act (Chapter 50) The Report of the Inspectors appointed by the Minister for Finance. Michael Lim Choo San, Nicky Tan Ng Kuang Partners of Price Waterhouse Counsel to the Inspectors VK Rajah, Sundaresh Menon, Partners of Rajah and Tann Appendix 1E para., 9

[115] Ibid., Appendix 1E para., 16

[116] The Accountants', Joint Disciplinary Scheme Annual Report (1999)

- all banks and securities firms should be subject to effective supervision, including the supervision of capital;
- geographically and/or functionally diversified financial groups require special supervisory arrangements;
- all banks and securities firms should have adequate capital;
- proper risk-management by a firm is a pre-requisite of financial stability;
- the transparency and integrity of markets and supervision rely on adequate reporting and disclosure of operations;
- the resilience of markets to the failure of individual firms must be maintained;
- the supervisory process needs to be constantly maintained and improved."[117]

These ongoing initiatives and principles should enhance the co-operation of regulators but it is inevitable that it will take another disaster across financial sectors to really assess whether the Joint Statement has changed the political will of states.

A further problem with consolidated supervision exposed by the Barings collapse was that solo consolidation had made authorised banks prone to greater risks from poor co-operation between regulators, for unlimited risks have to be absorbed by them. This required the Bank to ensure that solo consolidation takes place only with the agreement of management. More importantly, solo consolidation should be allowed only where the appropriate controls and monitoring mechanisms for managing risks within institutions are in place, whether or not they are institutions in the same jurisdiction. What the Barings collapse highlights about consolidated supervision is that it is effective only when appropriately implemented and monitored.

### 3.4.3 The FSA and Co-operation with Overseas Authorities

Under s.354(1) of the FSMA 2000, the FSA is under duty to co-operate with 'other persons', which includes authorities similar to it in the UK *and elsewhere* (s.354(1)(a)), by doing 'whatever it considers appropriate to co-operate', including

[117] The Basle/IOSCO Joint Statement of April 1996

efforts to combat international financial crime: This rather ambiguous provision, like the other duty provisions, does not impose a statutory obligation on the FSA. Instead, it has a status similar to that of the clauses that outline its responsibilities under the FSMA 2000: It constitute the platform, together with a range of formal MoUs, on which it can co-operate with extra-national authorities. This power differs from that provided by s.9(3) of the Banking Act 1987, which enabled co-operation when a foreign institution is situated in the UK but its principal place of business is elsewhere. The substance of s.354 of the *FSMA* 2000 will be fleshed out by the existing MoUs that the FSA will be required to honour on behalf of the previous regulatory bodies.

An interesting feature of the new regulatory regime is that s.354 will be assessed on the basis of the FSA's regulatory objectives expressed in s.2(1) and (2), which are essentially territorial, whereas the provision for co-operation with extra-national regulators may see a wider notion of 'public interest' included in the statutory framework and legitimated under the s.2(2)(a) provisions about market confidence and s.2(2)(c) provisions about consumer protection, both of which have the capacity to transcend national boundaries. Therefore, the FSA could be accountable not only in terms of its domestic functions but also (and rightly) in terms of its international function of co-operating with other competent authorities. Even though reciprocity, is not expressed in this set of provisions, will nevertheless play a key role in how co-operation will flesh out.

### 3.4.4 Lead Regulation

The concept of 'lead regulation' evolved independently of `consolidated supervision' to manage the regulatory chain which existed to supervise a multi-authorised group of institutions across various business forms, and originated from the 1986 Big Bang and the introduction of the Financial Services Act 1986 and the Banking Act 1987. The policy of having a lead regulator meant that the Bank, for prudential purposes, was to be responsible for group activities in the capital-adequacy domain. However, with the establishment of the FSA, a revised lead-regulator policy was devised because of the integrated way in which regulation and supervision of various forms of financial business is now controlled. The responsibility of the lead regulator was to ensure the flow of information across the various regulatory bodies and assess the compliance of the institution with the prudential regulation governing its activities on a consolidated basis.

Under the new FSA Guide the lead supervisor will be established on the basis of the 'predominant business test',[118] and chosen from either the Complex Groups Division or from one of the Divisions responsible for that particular type of business. Therefore, a predominantly banking group will have either a lead supervisor from the Complex Groups Division or from the Banks and Building Societies Division. However, under the existing arrangements the test is not clearly defined. While `predominant business' might be identifiable, the FSA has not actually clarified whether it will make such identifications on the basis of profit or turnover, or whether it will simply accept the traditional identification in terms of which an institution is authorised. This will be an issue for retail banks such as Lloyds TSB, which generate a large proportion of its profits from insurance business. In such cases, while the financial group is always perceived to be banking-orientated, its profits result from insurance business. The Guide does note that in some instances the traditional lead-regulator has been replaced by a new lead-supervisor. In many instances this is the direct result of changes in the financial-services industry, as discussed in Chapter 1.[119]

It is important to note that `lead supervisor' does not replace solo supervision by the designated regulatory division, but rather, is a complementary procedure for effectively supervising the diverse range of risks in complex organisations. While lead-supervision can enhance efficiency and reduce regulatory overlap in financial conglomerates through a single approach, in the UK such supervision inevitably requires co-operation with regulators in other jurisdictions. This condition was not abundantly present in some situations, and particularly not in the Barings incident, which highlighted problems not only of a jurisdictional nature but also in the attempts at co-operation between differing regulatory bodies.

[118] SUP 1.5, see further, FSA, Supervision of Complex Groups, London, Financial Services Authority (1998)
[119] Chapter 1 The Evolution of Banking and Financial Regulation at p. 29

## 3.5 Capital Adequacy

The fact notwithstanding that the FSA is now the competent authority for applying and developing capital-adequacy guidelines, those guidelines were devised by the Bank when it was responsible for banking supervision.[120] Capital standards have a significant impact on the competitiveness of authorised institutions, hence the importance of converging them internationally. Those standards have become the focus of regulatory-policy process in recent years.[121] Holding capital disciplines management to provide a cushion against risks, and capital acts as the financial charge of a bank's decision-making. For reasons of competitiveness and profitability, effective design of standards is considered critical. It will be seen that the design of capital-adequacy measures has evolved with the changing nature of banking business. For authorised banks themselves, the incentive of holding differing grades of capital means that capital can act as a source of funds.

Today's capital-adequacy measures stem from the convergence process that was made necessary by the instability in the world capital-markets caused by world recession, and by over-exposure to specific counterparties and innovation in the capital markets. These changes exposed the inadequacies of the earlier regulatory tools for bringing bank activities,[122] particularly those concerning adequacy of capital and provision against bad and doubtful debts, into line with standards designated by the Bank and other overseas regulators. The response to the resultant turmoil was a re-assessment of the prudential requirements of recognised and licensed institutions and a consequent moving-away from discretionary, individual approaches towards standardised prudential controls, especially in the international arena, for UK capital-adequacy standards differed considerably from those of Continental Europe and the US. The Governor of the Bank of England noted that:

> *"the existence of widely divergent prudential standards as between different centres threatens, in my view, the effectiveness of supervision in all. The approach to reduce systemic risks was however, bilateral, even though a*

[120] IPRU CO: S. 1 at p. 1-1
[121] E P M Gardener, 'Capital Adequacy Convergence and its Impact on Banks and Regulators', in R Kinsella (ed.), *New Issues in Financial Services*, Oxford, Blackwell (1992)
[122] Treasury and Select Committee Fifth Report, Report and Proceedings, London, HMSO (1982-1983)

*multilateral standard was considered more appropriate for other financial centres to follow.*"[123]

The renovated approach to reducing systemic risks formulated a common notion of what capital amounted to and re-estimated the risk-weights that should apply to the various forms of business undertaken by banking institutions in the US and UK. The Bank's earlier system for measuring capital-adequacy assessed credit risk with a gradation of risk weights. The type of capital included in each of the Three Tiers remains the basis for the measurement of capital to date.[124] The new arrangement takes into account on-balance-sheet transactions and assesses the impact on the adequacy of capital of off-balance-sheet transactions. This and other innovative financial instruments apply the primary-capital ratio (a ratio of total capital to weighted-risk assets that includes off-balance sheet instruments) to each bank.

The structure of the risk-asset ratio consists of various weightings, depending on the obligor. The proposals were recognised by Japan, and later the other G-10 countries followed suit by accepting the capital-adequacy standards. Basel played a large role in formulating a method of measuring capital and capital standard to take into account both credit risks from exposures and from on-and-off balance-sheet transactions. The Basel Accord superseded the US/UK Accord and differed with it on what amounts to 'capital' and about the risk-weightings on certain securities such as government securities: the Basel arrangement assigned a 0% risk weighting, whereas the US/UK one had assigned a 10% risk weighting[125] to such securities. This highlighted the importance of international convergence[126] to reduce the likelihood of competitive inequality among international banks.

The European Economic Area recognised the importance of convergence and decided that the European Directives should be in line with those proposed by the

[123] Bank of England, 'Consultative Document, Convergence of Capital Adequacy in the UK and US' Banking Supervision Division, Bank of England, January (1987)
[124] IPRU, CO: S. 2: Page 1-4 at para., 2.1
[125] For an extensive examination see, J J Norton, *Devising International Bank Supervisory Standards*, London, Graham & Trotman / Martinus Nijhoff (1995) at pp. 190
[126] E B Kapstein, (1989) op. cit., n. 18, at p. 344

Basel agreement,[127] which is implemented by the UK.[128] This was deemed crucial for ensuring consistency between the Basel framework and the one deployed in the European Community. The factor that distinguishes the two regimes is that the Basel agreement refers to international banks, whereas the European regulations refer to credit institutions that may not be internationally active.

The convergence of capital standards did have its critics. The alternative had been the power of national regulatory-authorities to exercise discretion in interpreting key determinants, such as what to classify as Tier 1 and 2 capital, which could of seen the inclusion of poor-quality capital in the Tiers. The measurement of capital by risk-asset ratio does not necessarily reduce state discretionary power, for it requires the national authority to use it only as the token objective element of a primary-point of examination, 'within their overall (subjective) evaluation exercise'. [129]

Although the Basel proposals apply to the G-10 international banks, the UK proposed, under the Banking Act 1987, to apply the Basel convergence-agreement standards to all authorised institutions. The FSA continues to require authorised institutions to meet the agreed level of 8% in conformity with Basel. Banks are required to maintain the 8% ratio which is deemed the absolute minimum for this Act's purposes. However, the trigger-ratio is actually set much higher, relative to other similar banks, and acts as a warning sign to the FSA: if it falls it means a bank has insufficient capital to safely support the risks it is undertaking.[130] The target-ratio is distinguishable from the trigger-ratio in that it acts as a 'warning light' that trigger-ratio is about to be breached.[131]

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[127] For an examination of the Basle Accord, see M Goldstein, David Folkerts-Landau, et.al, *International Capital Markets: Developments, Prospects, and Policy Issues.* Washington DC, International Monetary Fund (1996) at p.10-15

[128] Bank of England, Banking Supervision Division, 'Notice to Institutions Authorised under the Banking Act 1987 Implementation of the Basle Convergence Agreement in the United Kingdom', No. BSD/1988/3, October 1988

[129] M J B Hall, 'The BIS Capital Adequacy "Rules" - A Critique', June, *Banca Nationale Del Lavoro Quarterly Review*, (1989), 207-27 at p. 215

[130] IPRU CO: S. 4 at para., 4.1.1

[131] Ibid., CO: S. 4 at para., 4.1.2

The European focus is based on two directives: the Own Funds Directive,[132] and the Solvency Directive,[133] which were adopted by the Bank.[134] Neither directive diverges a great deal from the previous method of assessing capital adequacy. The Own Funds Directive provides the competent authorities in the internal market with a provision to establish what constitutes 'Tier 1' core capital and 'Tier 2' supplementary capital, and the way in which total 'own' funds are to be calculated. The Directive also highlights that its provisions are in accordance with international guidance on what amounts to 'funds for general banking risks' and that it is in compliance with them. This is to ensure that there is general consistency between international standards and European standards. The Solvency Directive implements a ratio which weights assets and off-balance-sheet items according to their degrees of credit risk. The measurement thus enables competent authorities to assess the solvency of a credit institution. The FSA's approach will be to use the 8% ratio as the rudimentary rule-of-thumb measure of minimal adequacy; in the majority of cases it is far higher, thus connoting super-equivalence. The Directive recognises the importance of capturing forms of risk other than credit risk, such as interest-rate, foreign-exchange and market risk, in the supervision of credit institutions. However, the solvency-ratio still tends to reflect the traditional risks to which banks are exposed, that is, credit risk from default of counterparty. The importance of a co-ordinated approach for setting capital-adequacy standards to capture the market-risks of bank and securities firms is essential in achieving a 'level playing field' between bank and non-bank securities institutions.[135] This is especially so since a large proportion of bank activity is of a securities-business nature, in clear departure form the traditional banking role of lending.

The Capital Adequacy Directive[136] (CAD) was implemented in the UK in 1995[137] and determines the minimum capital that credit institutions and investment

[132] Council Directive of 3 December 1991 Implementing Directive 89/299/EEC on the Own Funds of Credit Institutions
[133] Council Directive of 18 December 1989 on a Solvency Ratio for Credit Institutions
[134] See Bank of England, Banking Supervision Division. Notice to Institutions Authorised under the Banking Act 1987. Implementation in the United Kingdom of the Directive on Own Funds of Credit Institions. No: BSD/1990/2 and "...Implementation of the Solvency Ratio Directive", No: BSD/1990/3
[135] R Dale, 'The Regulation of Investment Firms in European Union (Part 1)', Issue 10, *Journal of International Banking Law*, (1994), 394-401
[136] Council Directive 93/6/EEC of 15 March 1993 On the Capital Adequacy of Investment Firms and Credit Institutions

firms are required to have in order to safeguard against market and other risks associated with their trading activities.[138] The Directive is a part of the international effort to bring about a co-ordinated approach to determining the capital-adequacy requirements of investment firms and credit institutions[139] engaged in direct competition with one another, and attempts to achieve equality of treatment upon a common standard in the supervision of market-risks that include position risk, counterparty/settlement risks and foreign-exchange risks. In order to supervise such risks, the directive and the Basel Accord both introduced the concepts 'banking book' and 'trading book.[140] The authorised institution and the FSA are required to assess the extent to which an institution is going to undertake trading activity, and to decide whether the size of that activity qualifies it for CAD recognition. The bank then has to construct for the FSA a policy-statement acceptable to its directors.

The trading book outlines the roles of securities and financial instruments with regard to trading that is likely to expose an institution to specific market risks. It consists of market-risk instruments and instruments that measure transmitted credit-risk. For the purposes of the FSA, there are three main categories of trading book: a financial instrument; a financial instrument held for trading purposes; an instrument for hedging exposure in the trading book.[141] Short-term price movement is essentially the activity that the trading book depicts.

The Guide incorporates the 'banking book' introduced by the CAD and consists of everything which is not in the trading book. It defers to the Solvency Ratio Directive on what amounts to 'own funds' for authorised institutions[142] and 'counterparty default'.[143] This is notwithstanding the fact that particular instruments in the banking book do have particular market risks beyond the ones subsumed in the

[137] Bank of England, Supervision and Surveillance. Notice to Institutions Authorised under the Banking Act 1987 *Implementation in the UK of the Capital Adequacy Directive* No: S&S/1995/2

[138] C Lavoie, 'Consensus on the EC Capital Adequacy Directive (CAD): What will be the future cost of securities trading?', August, *Butterworths Journal of International Banking and Financial Law*, (1992), 361-364. S Tidball, 'Consensus on the EC Capital Adequacy Directive (CAD): Implications for UK Institutions', October, *Butterworths Journal of International Banking and Financial Law*, (1992) 462-464.

[139] 93/6/EEC op. cit., n. 136 at recital no. 7

[140] IPRU CB: S.1

[141] Ibid., CB: S.3

[142] Ibid., BC: S.1 at p.1, para., 1.1(1)-(2)

[143] Ibid., BC: S.2 at p.1

latter, and are given designated risk weightings.[144] These weightings are rather crude in that they lump various types of securities together in a way that does not necessary reflect their given risk weightings, and thereby artificially suggest that some government-securities are more securer than others. However, government securities are more secure than any other kinds of securities.

### 3.5.1 Capital Adequacy and Internal Models

The foregoing discussion has already noted that the standardised approach to capital-adequacy has come under criticism because of its inflexibility on how capital-against-risk should be managed. In many respects, the recognition afforded to internal models has motivated institutions to innovate in risk-management strategies rather than concentrate on ensuring that they quantitatively meet the existing capital-requirements and existing 'trigger' and 'target ratios'. Moreover, the nature of risk-management, given the developments in the area, is such that many of the standardised methods for calculating capital are deemed rather rudimentary in comparison with the methods used by some banks and investments firms for internal purposes. These concerns required Basel and the European Commission to re-amend their respective capital-adequacy policies to incorporate the use of internal models.[145] This resulted in a re-amendment of the Basel Capital Accord and European Capital Adequacy Directive, and in the re-named CAD II,[146] implemented on 30 September 1998, which allows banks to use a wider range of internal models.[147]

The models of the CAD I standard approach go through a process of recognition to ensure they can be used for the purpose of capital-adequacy calculation. This process includes the models themselves and the operating environment in which they function.[148] An authorised institution might have a number of models for calculating the various types of risk it is taking in its various businesses. The model review-process is an integral part of the overall risk-based approach to

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[144] Ibid., BO: S.1 at p. 1, para., 1.1(2)
[145] M Elderfield, 'Basle Publishes Final Market Risk Capital Standards', March, *Butterworths Journal of Banking and Financial Law*, (1996), 125-127.Chris Bates et al, 'CADIII moves forward', January, *FT, Financial Regulation Report*, (1998) 2-4. N O'Neill et al, 'CADII Moves forward – Proposals to Amend the EU Capital Adequacy Directive', Issue 5, *Journal of International Banking and Financial Law*, (1998), 178-180.
[146] CADII – 98/31/EC
[147] IPRU, TS: S.1
[148] Ibid., TS: S.2

supervision. The CADI models are systematically reviewed, prior to their recognition by the FSA, during on-site visits and on the basis of pre-visit information. The review process performs a systemic assessment of the model, of the conditions to be met in using it, and of the systems and controls that underpin its function. It was then obliged to formally declare that it accepts the responsibilities attendant upon its proper use.

The FSA recognises the admittance by CADII of the use of internal models for measuring market-risks in calculating capital requirement.[149] (The utilising bank is required to satisfy a number of qualitative and quantitative standards.) The admittance had become necessary because some banks had in place measuring systems that were more sophisticated than the CAD standard-approach ones, and those banks had to be allowed to benefit from the use of them. Moreover, the admittance was an incentive to banks to measure market-risks with more precision.

The Value at Risk (VaR) measure provides an estimate of the worst-expected loss on portfolio that is a result of market movements over a period of time.[150] The internal models undergo a recognition-process consisting of on-site visits and off-site assessment by the Traded Risk Department and external auditors. The qualitative standards[151] a model has to fulfil are extensive and focus on internal controls, management, and the resources that underpin the functioning of the model. Included in its recognition-process is a programme of stress-testing that can betray its vulnerabilities, and a regular review by internal auditors to assess its risk-measurement capabilities. The 'recognition process', has quantitative standards to ensure that internal models produce a consistency of results across banks and have a 99% confidence limit over a ten-day holding period.[152]

There is consensus on the use of internal models.[153] However, they are not a panacea but the inevitable outcome of growth risk-measurement strategies. According to Danielsson, VaR has a number of limitations and in some respects actually increases the vulnerability of institutions because it may provide false impressions of

149 Ibid., TV: S.1
150 Ibid., TV S. 2 at para., 2.5
151 Ibid., TV: S. 4
152 Ibid., TV: S. 5

the degree of risk an institution is exposed to.[154] It is therefore necessary for regulators to be cautious of internal models, particularly when they are the product of the institution using them. Regulators must scrutinise information closely in order to ensure that an institution's true risk-exposure is portrayed. Hendricks shows a high degree of pragmatism in his attitude to regulating internal models by suggesting that their introduction does not necessitate the overhauling of regulatory expertise, but rather, the maintenance of a staff with a high degree of technical skill and experience in reviewing bank-trading operations.[155]

### 3.6 Large Exposures

The examination of capital-adequacy and consolidated-supervision also requires an examination of the FSA's approach to large exposures[156]. The issue of large exposures gained prominence in the UK after the collapse of Johnson Matthey Bankers Ltd. The Leigh Pemberton Report highlighted the importance of controlling large exposures with the repeal of the Banking Act 1979. The EC directive on the monitoring of large exposures[157] was built on the Commission's Recommendation.[158] It allows the regulator to monitor the excessive concentration of exposure to a single client, or group of connected clients, that could result in excessive losses or seriously affect the solvency of a credit institution.[159] The broad policy reason for the regulation of large exposures is to prevent a distortion of the competitiveness of credit institutions in member-states by allowing banks to over-expose to particular counterparties.[160] The provisions of the directive indicate the importance of laying down specific standards for exposure by a credit institution to its own group.

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153 D Hendricks & B Hirtle, 'Bank Capital Requirements for Market Risks: The Internal Models Approach', December, *Federal Reserve Bank of New York Economic Policy Review*, (1997), 1-12

154 J Danielsson, 'The Emporor has no Clothes: Limits to Risk Modelling', (Preliminary draft) Presented at Financial Markets Group? LSE conference: Rules, Incentives and Sanctions: Enforcement in Financial Regulation, May (2000)

155 Hendricks, *et al*, (1997) op. cit., n.153, at p. 9

156 IPRU LE: S.1-S.2

157 Council Directive 21 December 1992 on the monitoring and control of large exposures of credit institutions 92/121/EEC

158 European Community, 'Recommendation on common guidelines for monitoring and controlling credit institutions' large exposures' 87/62/EEC

159 R G Lee, 'The Monitoring and Control of Large Exposures: A view from the United Kingdom', Issue 4, *Journal of Banking and Financial Law*, (1992), 125-130

160 R M Pecchoili, *Prudential Supervision in Banking*, Paris, OECD (1987) at p. 74

Consolidated supervision of large exposures is required to effectively monitor exposure to the authorised institution as part of a group. That encourages banking groups to co-ordinate their monitoring systems for controlling intra-group exposures. The approach of the directive is essentially in line with the Bank's original approach. However, the directive places greater emphasis on explicit limits on the size of exposure that an authorised institution can be allowed. The Bank proposed that these limits run parallel to those stipulated in s.38 of the Banking Act 1987. This fact notwithstanding, the assessment of large exposures is based on the maximum loss experienced from the failures of the counterparty.

The FSA's approach follows the Bank's traditional approach to monitoring large exposures of banks and banking groups at both consolidated and unconsolidated (solo) levels. The FSA requires that an authorised institution set out its own policy on large exposures, including exposures to individual customers, banks, countries and economic sectors. In the case of incorporated banks in the UK, the board of directors is to formally adopt a policy statement, and the FSA will not allow significant deviations from it without prior discussions. Only in the most exceptional circumstances is a bank allowed to exceed the 25% level of capital-base exposure,[161] and it has to provide notification on a quarterly basis of the state of its exposure. The FSA would increase the level of enquiry if the level of exposure exceeds 10%, but the approach relies on a bank's not exceeding the 10% limit.

The FSA will determine whether an institution is in breach of s.38 or Schedule 3 of the Banking Act 1987 by reviewing a bank's policy statement, particularly on the maximum exposure it contemplates, and assessing the standing of the counterparty and the relationship between that bank and a connected counterparty. A single exposure to one counterparty is not to exceed 25% of the unconsolidated capital base. In banking groups the exposure cannot exceed 25% of the consolidated capital base. The FSA will want also to examine large-exposures policy to determine how a bank will monitor the size of its capital base to ensure that the limits in the Guide are not exceeded.

161 IPRU, LE: S.9

Like capital-adequacy and consolidated-supervision, large exposure-policy has also come under criticism. The Barings collapse highlighted the need for scrutiny and monitoring of large exposures incurred by an authorised institution. The concessions given to Barings clearly exceeded the limits imposed by the EC Directive, and they were not investigated promptly. In future, such concessions will require the formal approval by the Head of Division, which will obviate the possibility of granting informal concession that should not have been granted in the first place, such as the concession that allowed Barings to exceed the 25% capital base-limit on the Osaka Stock Exchange. (It must not be forgotten that this concession was given without authorisation by SIMEX and resulted in a 73% exposure.) The recommendation after the Barings collapse was to make sure that any breach of a concession is immediately investigated and brought to the attention of the Board of Banking Supervision.

### 3.7 Conclusion

This Chapter identified some of the important legal aspects of prudential supervision governing banking institutions. Through authorisation, deposit institutions have not been prevented from entering other forms of regulated business such as the investment business. It was demonstrated that the reason for allowing the growth of bank-financial conglomerates is that there are effective standards in place for prudential supervision to capture the various risks to which such conglomerates are subject. Developments in prudential supervision have made it safe to allow institutions to participate in a diversity of business forms. It is clear that prudential supervision does not seek to reduce the likelihood of fraud or other forms of malpractice, but that instead it seeks to ensure the stability of a bank, and thus to reduce the likelihood of loss to depositors. The importance of safeguarding depositors' interests, and ultimately the wider economy, has meant that a global strategy has become important too. This is clear from the internationalisation of banking and capital markets. Furthermore, the identification of new varieties of risk means that regulatory strategy has to pay attention to more risks than the Banking Act 1987 was designed to guard against. Many of the new credit risks stem largely from the deposit business. However, with the growth of conglomerates, market-risk is equally important. The monitoring of large exposures means that authorised institutions are not vulnerable to a particular sector or counterparty. This requires regulation on a consolidated basis so that risks of an internationally active bank-financial conglomerate can be captured to determine whether the risks faced in the component parts of the group undermine the interests of depositors.

Capital-adequacy standards are a central cushion against risks. These standards have partly evolved by international consensus. There are strengths and weaknesses in the weighting rules devised. Capital standards, it was argued, increase the propensity for taking particular types of risk (*e.g.* market risks) domestically and internationally, and the higher the level of capital, the greater the propensity to venture risk.

# Chapter 4

# Corporate Governance and Banking Supervision

## 4.1 Introduction

An evaluation of the relationship between the regulator and regulated requires an examination of corporate governance as an essential basis for effective prudential supervision. In the preceding Chapter, the tools of prudential supervision were considered and it was shown that regulatory resources have traditionally focused on enhancing the competitive position of banks in relation to securities houses to achieve a somewhat elusive 'level playing field'. It was concluded that capital-adequacy and solo/consolidated supervision provides an open gateway for assessing the risks of banks, and in the former, a cushion against the various forms of risk. Effective corporate governance, on the other hand, provides the essential basis for reducing the likelihood of fraud, risk of damage to reputation, or in the worst-case scenario, collapse or closure. Evidence from various bank closures and other financial failures show that regulators need to pay more attention to issues of governance. Mechanisms for governance, that ensures trust and co-operation between the regulator and the regulated.

This Chapter focuses on the interests of depositors protected under the deposit protection scheme rather than on investor-depositors who are the shareholders of regulated institutions. Section 1 and 2 outline what is meant by 'corporate governance' and to show that a number of stakeholders other than shareholders, such as depositors and regulators, exist in authorised institutions. This means that authorised institutions which are profit-maximising institutions need to consider, for example, the interests of depositors when exercising their business judgement. In sections 3, 4 and 5, the various facets for effective corporate governance are analysed, starting with why effective internal controls other than financial controls are necessary. These sections will consider also the standard of care required by approved firms. The effectiveness of internal auditors and audit committees is addressed, with reference to domestic and international literature, in order to determine the contribution they can make to the relationship between regulator and regulated. In sections 6, 7 and 8 an analysis of the traditional role of directors and senior management is undertaken, with focus on the s.16 Statement of Principles and the FSA Principles governing Approved Persons. This assesses also the contribution from case law (evolved from the Company Directors (Disqualification) Act 1986) to the overall design of the standard of care principles of the new regulatory regime. Section 9 draws together the various strands which suggest that regulators have essentially mirrored commercial practice and thus enshrined the idea that their 'entrepreneurial spirit' is secure, provided it satisfies supervisory objectives.

### 4.2 Corporate Governance

The issues of corporate governance are not simply a domestic concern[1] but a much wider one that includes commercial and regulated institutions. This examination of corporate governance looks at the general issues with reference to the regulation and supervision of banks.[2] It will focus on the role of the Bank and the FSA and the Basel Committee.[3] In an attempt to examine the level of control and accountability to identified stakeholders. The growing importance of corporate governance with the resurgence of management responsibility and effective accountability mirrors the limits of regulation.

The relationship between regulator and the regulated is one of trust and co-operation in which the traditional autonomy of the authorised institution is preserved. Indeed, the onus is on the authorised institution to co-operate by providing timely information,[4] and is ensured by compliance and deterrence strategies such as 'remedies' and 'disqualification'. The idea of voluntary co-operation or self-regulation can be successful if the regulated value the importance of it. Perhaps it would be more effective than involuntary co-operation. It is important in a system of enforced corporate governance to ensure that there are mechanisms in place for monitoring compliance with appropriate levels of integrity, professional skill and

[1] OECD, *Principles of Corporate Governance*, Directorate for Financial, Fiscal and Enterprise Affairs. Ad Hoc Task Force on Corporate Governance OECD Paris, 1999 SG/CG(99)5; A Dignam, 'Exporting corporate governance: UK regulatory systems in a global economy', Vol. 21, No. 3, *The Company Lawyer*, (2000), 70-76

[2] L Halme, 'Bank Corporate Governance and Financial Stability', at p. 32 in L Halme, *et al*, *Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline*, London, Centre for Central Banking Studies, Bank of England (2000)

[3] Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*. Basel Committee on Banking Supervision, (1999)

[4] FSA, Reporting Requirements (2001)

vigilance. It is suggested that this approach is theoretically the most appropriate in terms of time, cost-effectiveness and increase in the efficiency of regulation.[5]

Prudential supervision does not necessarily reduce the likelihood of fraud or collapse.[6] Therefore particular attention has to be paid to effective mechanisms for ensuring governance in corporations, because the responsibilities of regulators are limited. For example, it is not the regulators' legal duty to detect fraud, nor, for that matter, the external auditors' duty.[7] Rather, an integral part of the regulator function is the detection of criminal acts, although enforcement officers eventually deal with those acts.[8] The courts are reluctant to hold the regulator responsible for the actions of third parties, who are essentially 'profit making institutions' and for whom profit and loss are the results of 'commercial decisions'.[9] Indeed, even when institutions are the subject of fraud or its instigators, the issue becomes a point of governance, in terms of accountability to shareholders and regulator.[10] The turbulence created by such events shows that regulation (rules and standards) is needed, and that market co-operation is essential for the efficient functioning of companies. Therefore a balance needs to be struck between regulation and the market, such that the market disciplines itself in areas where cost of accountability is a significant issue. According to the Cadbury Committee, 'competitive spirit' should be paramount in a framework of effective accountability. The conflict between 'competitive spirit' and the limits of regulation highlight the importance of appropriate internal mechanisms for effective corporate governance.

### 4.2.1 Defining Corporate Governance

According to Maw, corporate governance is an 'ill-defined' and broad concept that is 'blurred at the edges'.[11] Many have attempted to define it.[12] It is interpreted from a number of theoretical perspectives placing emphasis on either the shareholder

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[5] I Ayres & J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford, Oxford University Press (1992) at p. 101
[6] See Chapter 3 Legal Aspects of Prudential Supervision
[7] See Chapter 6 The Role of Auditors and Reporting Accountants in Banking Supervision
[8] See Chapter 5 Enforcement Methods and Sanctions in Banking Regulation and Supervision
[9] See Minories Finance Ltd v Arthur Young (Bank of England third party) Johnson Matthey v Arthur Young (Bank of England third Party) [1989] 2 All ER 105 at p. 110 and Chapter 7 The Accountability of Regulatory Decisions at p. 263
[10] See Chapter 7 Accountability of Regulatory Decisions at p. 248
[11] N G Maw, *Maw on Corporate Governance*, Aldershot, Dartmouth Publication & Co (1994)
[12] S Sheikh & S K Chatterjee, 'Perspectives on Corporate Governance', at p. 1-56 in S Sheikh & W Rees, *Corporate Governance & Corporate Control*, London, Cavendish Publishing Limited (1995)

or the interests of more remote stakeholders.[13] Corporate governance is defined and structured differently across jurisdictions.[14] The literal meaning of 'governance' derives from the infinitive 'to govern'.[15] It connotes 'authority to undertake activities based on rules or standards to direct a particular course of action or influence change'. 'To govern' highlights the importance of authority and the responsibility to direct and control designated activities. In this section, it is submitted that a wide interpretation of 'corporate governance' is appropriate when the reference is to regulating institutions either internally or externally, because of the inter-dependency of these two broad components in the regulated sector.

Though the literal meaning of 'governance' centres on 'authority' and 'supervision', 'accountability' is equally important in a corporate context.[16] Accountability has become a significant part of internal and external governance in the modern corporate sense. For Keasey, accountability involves the monitoring, evaluation and control of organisational agents.[17] For others, accountability is inevitable when management is responsible for other people's money.[18] A fundamental recognition in corporate-governance policy is that accountability should not undermine the entrepreneurial spirit of a corporation. This is the conclusion of the Hampel Report that governance and accountability should not override the importance of shareholder investment:

> "*The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the last few years to the detriment of the former. We wish to see the balance corrected.*"[19]

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[13] G P Gilligan, 'Regulating companies in an era of late – modernity', Vol. 21, No.5, *The Company Lawyer*, (2000), 145-150

[14] The background to the change in the financial markets see, Chapter 1 The Evolution of Banking and Financial Regulation. P J N Halpern, 'Systemic Perspectives on Corporate Governance Systems' p. 1-58 and for an examination of governance structures of banking institutions across several jurisdictions see, I Walters, 'Capital Markets and Control of Enterprises in the Global Economy', in S S Cohen and G Boyd, *Corporate Governance and Globalization: Long Range Planning Issues*, Cheltenham, Edward Elgar (2000) at p. 95-128

[15] Oxford Compact, *English Dictionary*, Oxford, Oxford University Press (1996) at p. 429

[16] R I Tricker, The Corporate Policy Group, *Corporate Governance: Practices, Procedures and Powers in British Companies and their Board of Directors*, London Gower (1984) at p. 7

[17] K Keasey, *Corporate Governance: Economic and Financial*, Oxford, Oxford University (1997) at p. 67

[18] A Smith, *An Inquiry into the Causes of the Wealth of Nations*, London, Random House (1937) at p. 31

[19] Committee on Corporate Governance, *Report of the Committee on Corporate Governance*, London, Gee & Co (1998) (Hampel Report) at s. 1, para., 1.1

A system of accountability instils confidence into the minds of depositors and investors but it differs from 'entrepreneurial spirit' which is a matter for corporate governance. Whereas the former encourages investors to invest the latter encourages stakeholders to promote the interests of the corporate body.

In its narrow sense, 'corporate governance' centres on the relationship between management and shareholders, focusing on the return on shareholder wealth. In a rather ambiguous way the Cadbury Code takes the same approach.[20] According to it, '[c]orporate governance is simply the system by which companies are directed and controlled'. The words 'directed' and 'controlled' span the wider responsibilities elaborated upon in the Code of Best Practice. Those are the responsibilities incumbent upon boards of directors, shareholders and auditors in the pursuit of good corporate relationships. In a similar vein, Shliefer and Vishny define 'corporate governance' as a process that 'deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'.[21] This is so notwithstanding the fact that their interpretation focuses on profit-making institutions, even though *non*-profit-making organisations operate on the same basis. The basis of the relationship between investors and management is an implicitly contractual one in which management undertakes the responsibility of maximising the protection of investors' interests.[22] In this relationship the principal parties are the shareholders and directors. The directors are the shareholders' agents and are deemed to act on their behalf. Consequently, while the boards of directors in reality are responsible for relations with a broad range of stakeholders, they are deemed accountable only to shareholders.[23]

Company law is based on the idea of directors serving the interests of the company and shareholders as a whole. The idea of shareholders as the owners and directors as stewards is not an appropriate description of the actual relationship between directors and shareholders of public companies.[24] Directors', exist in the constitutional basis of an incorporated institution in order to act in its interest.

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[20] Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance*, London Gee & Co (1992) (Cadbury Report)
[21] A Scheifer & R W Vishny, 'A Survey of Corporate Governance', 52, *Journal of Finance*, (1997), 737-783 at p. 737
[22] M Bradley, et al, 'The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads', 62, *Law & Contemporary Problems*, (1999) at p. 9
[23] Hampel Report, (1998) op. cit., n. 19, para., 1.7

According to Lord Wensleydale, shareholders have limited influence on decision-making because the powers to direct the company are vested with the directors of the company.[25] However, this explanation does not consider the Anglo-American system of directors who are also shareholders. In the case of banking-supervision, shareholder-controllers are vetted for their 'fit and proper' condition. More importantly, comfort letters are provided by shareholders to identify their wider responsibilities in the event of problems.[26]

Governance in authorised institutions is framed within the traditional principal-agent model. However, 'corporate governance' can be interpreted from a wide perspective that embraces supervision of and accountability for all aspects of a company and to a broad range of stakeholders, not just shareholders and creditors. According to Blair, 'corporate governance', in identifying the economic and social contexts within which corporations function, has a wider context of application than the 'agent-principal' model. Its framework suggests that directors have a responsibility to a broad range of stakeholders with whom, as a corporation, they deal. Therefore, an interpretation of 'corporate governance', could include employees, suppliers and the community. On such an interpretation, a company would need to take these parties into account in its system of allocating risks, returns and controlling activities.[27]

The wide interpretation of 'corporate governance' is applicable to banking institutions because of their broad role in the economy. The efforts of the OECD were the inspiration for the Basel Paper, reinforcing the importance of effective corporate governance. Like the OECD Report, the Basel Paper does not advocate any one particular internal or external approach to corporate governance, but rather, suggests broad principles that can be implemented into existing structures. These principles and recommendations of the two documents act as guides for member states, with the ultimate goal of promoting effective governance. The Basel Paper applies the OECD definition of 'corporate governance' to effectuate good governance in banking institutions. Corporate governance involves:

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[24] Mayson, French & Ryan, *Company Law*, London, Blackstone Press Limited (99-00) at p. 401
[25] *Ernest v Nicholls* (1875) 6 HL Cas 401
[26] IPRU (Bank) Comfort Letters CL: S. 1-2
[27] M M Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, Washington DC, Brookings Institution (1995) at p. 3

*"[A] set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."*[28]

The OECD provides a broad definition of 'corporate governance', identifying both internal and external requirements for effective and efficient governance, and, though clearly based on the basic relationship of company-and-shareholder, it recognises the importance of other stakeholders in the ambit of governance. The definition suggests that a board of directors and management should focus on pursuing the interests of a company and its shareholders. The Basel Paper places the onus for effective corporate governance on the board of directors and management, but because of the regulatory context with which they function, regulators, government and other trade associations also have a responsibility for promoting good corporate governance. The Basel Paper builds upon this by recognising that banking institutions are accountable to a number of stakeholders rather than being simply required to recognise other stakeholder interests.[29] The board of directors govern the affairs of the business and must take into account:

- corporate objectives (including generating economic returns to owners);
- the day-to-day operations of the business;
- interests of recognised stakeholders;
- the alignment of corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner and in compliance with applicable laws and regulations;
- protecting the interests of depositors.[30]

The broad objectives of corporate governance are translated into particular measures to ensure internal and external governance within the wider economy. Such measures are:

[28] Basel, *Enhancing Corporate Governance*, (1999) op. cit., n. 3, at p. 3, para., 7
[29] *Cf*, *Hampel Report*, (1998), op. cit., n. 18, para, 1.17
[30] Basel, *Enhancing Corporate Governance*, (1999) op. cit., n. 3, at p. 3, para., 9

- establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation;
- setting and enforcing clear lines of responsibility and accountability throughout the organisation;
- ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns;
- ensuring that there is appropriate oversight of senior management;
- effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide;
- ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment; and
- conducting corporate governance in a transparent manner.

These measures are strategies to ensure that banks fulfil the objectives noted above. The factors that banking institutions need to take into account stress the importance of environment. Although they are clearly profit-making institutions, they are required to be mindful of the effects of their business by respecting the regulatory and supervisory rules. These determine what they can and cannot do, to operate in a safe and sound manner and to protect depositors. The Basel Paper provides a broad definition of 'stakeholder':

> "*'stakeholders' include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and the financial systems, supervisor and government are also stakeholders.*"[31]

This broad definition of 'stakeholder' is based on the unique role of banks, which is not confined to the maximisation of shareholder wealth. As recognised by the Basel Paper and Chapter One of this work, banks, like other financial institutions, play an essential role in the economy as financial intermediaries. For example, banks participate in the 'Wholesale Money Markets' and act as intermediaries in the governmental role of monetary management. These roles have traditionally required particular safeguards, such as the 'Lender of Last Resort' function, against systemic crisis or contagion. For the general deposit-taking business, a formal Deposit

[31] Basel, *Enhancing Corporate Governance*, (1999) op. cit., n. 3, at p. 3

Protection Scheme is in place to safeguard the interests of small deposit-takers. These are *ex post facto* measures that attempt to prevent fall-out from regulatory failure. *Ante-post* measures of regulation and supervision safeguard financial stability through prudential supervision.[32] In order to avoid over-regulation, strong corporate governance is essential.

In the light of the Basel Paper, the UK regulatory order is such that the FSA as regulator, the Bank of England as the central bank, and the Treasury, are stakeholders whose interests need to be considered by the banking institution. Sound corporate governance requires that the interests of all stakeholders be taken into account, including depositors'. The Basel Paper specifies that a board of directors and management need to consider the interests of depositors, but unfortunately, it does not elaborate on how they might do that successfully. Regulators are required to monitor whether banks have in place mechanisms for governance and for protecting their interests, which are vulnerable if monitoring is inadequate.

In the UK regulators have tended to develop regulation with the autonomy of an institution in mind. This approach enhances the 'entrepreneurial spirit' with which banking institutions perform their business. The risks that emanate from their activities require regulation because in a regulatory context the risks taken by banking institutions have a potential for broad economic repercussion. Hence the importance of effective corporate governance: Where corporate governance is effective, the regulator has a degree of responsibility to undertake on-site and off-site visits to ensure that an institution is aware of endangered risks that have come to that regulator's attention. It is crucial for effective corporate governance that appropriate internal arrangements exist. The following sections examine the contribution of internal controls, the role of internal audit and the audit committee.

### 4.3 Corporate Governance and Internal Control Systems

The concern for effective internal controls is not new in banking supervision[33]. The general definition of 'internal controls' is:

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[32] See generally, Chapter 3 Legal Aspects of Prudential Supervision at p. 69

[33] Basel, *Enhancing Corporate Governance*, (1999) at p. 3-4; R Kinsella, *Internal Controls in Banking*, Dublin, Oak Tree Press (1995); and Group of Thirty, *Global Institutions, National Supervision and Systemic Risk: A Study Group Report*, Washington DC, Group of Thirty (1997) at p. 12

> *"The whole system of controls, financial or otherwise, established in order to provide reasonable assurance of (a) effective and efficient operations; (b) reliable financial information and reporting; and (c) compliance with laws and regulations."* [34]

This definition, provided by the Interim Working Party, is generally accepted, notwithstanding the fact that other definitions have been proposed, because it identifies both financial and other internal controls. This is unlike the Cadbury Report's definition which, for the purposes of its broader agenda, focused only on financial controls.[35] It was considered too narrow and was eventually ousted by the Hampel Report's definition. The Hampel Report emphasised that financial controls are merely a part of the whole framework of internal-control systems, which includes both (a) and (c) of the definition provided by Interim Working Party. However, both Reports insist that good internal controls are the responsibility of a company's directors and senior management. Following this, the Cadbury Report recommended that directors should provide a report indicating the effectiveness of financial controls.[36] This recommendation occasioned significant debate about whether this would be appropriate, and lobbying of the Hampel Committee led to its abandonment.[37] The Hampel Committee recommended that the word 'effectiveness' be dropped from paragraph 4.5 so that it would say only that: 'The directors should report on the company's system of internal control'. A consensus supported the move to build on the existing reporting-requirements for directors and auditors. This led to a variety of reports on internal controls that identified the limits of a 'building-on' approach, tactfully pointing out its weaknesses.[38] Another issue of concern was the mechanism for assisting directors, such as internal audit and other compliance arrangements. The Cadbury and Hampel Reports encouraged the establishment of internal audit functions but they did not provide guidelines for the operation.[39]

The consequences of failing to monitor or to bring to the board's attention internal-control failures are clear in the *Daniels*[40] and *Barings* cases.[41] Both suffered

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[34] See for example the Auditing Practices Board Glossary of Terms
[35] Cadbury Committee, (1992) op. cit., n. 20 at para., 2.5-2.6
[36] Cadbury Committee, (1992) op. cit., n. 20, at para., 4.5
[37] Auditing Practices Board, *Internal Financial Control Effectiveness*, London, APB (Issued April 1995)
[38] M E Jones, 'Internal Control', Chapter 13, at p. 13-24 in Gee & Co, *Corporate Governance Handbook*, London, Gee & Co (1998)
[39] The important contribution of internal audit to the whole area of corporate governance is provided in Chapter 6 The Role of Auditors and Reporting Accountants in Banking Supervision
[40] *Daniels v Anderson* 16 ACSR [1995] 607

auditing and management failures in the detection and monitoring of staff-members with significant responsibilities. The various financial failures of the nineties showed that it is the lack of vigilance and monitoring that is likely to lead to such disasters, and they cast aspersion upon the idea of regulatory trust. A number of institutions caused depositors and investors to lose money, or they had some other adverse effect on market confidence: Johnson Matthey Bankers, BCCI, Morgan Grenfell, Barings, and in other jurisdictions, Daiwa Bank, Sumitomo Bank, US Thrift institutions. The Basel Committee has long contributed to the debate about effective internal control systems, specifically elaborating on their ability in principle to ensure the safety and soundness of banks. In its framework for internal controls, it identifies five root causes of bank failure:

- "lack of adequate management oversight and accountability, and failures to develop a strong control culture within banks;
- inadequate recognition and assessment of the risk of certain banking activities, whether on or off-balance sheet;
- the absence or failure of key control structures and activities, such as segregation of duties, approval, verification, reconciliation and review of operating performance;
- inadequate communication of information between management within the bank, especially in upward communication of problems; and
- inadequate or ineffective audit programs and monitoring activities."[42]

The Basel principles do not advocate any real change to the supervision of banking, they simply re-assert the importance of effective internal controls and systems, not by simple rhetoric but by suggesting active management and monitoring. The framework identifies three areas where improvements can be made to avoid governance failure: management, audit, supervision (to a limited extent). The framework encourages a vigilant management structure and encourages a culture for appreciating the importance of internal controls in an organisation, most importantly, of audit committees. Interestingly, banks are vulnerable where conflicts of interest is

[41] *Re Barings plc (No. 5), Secretary for Trade and Industry v Baker and others (No. 5)* Ch D [1999] 1 BCLC 433

[42] Basle Committee on Banking Supervision, *Framework for internal control systems in banking organisations*, Basle, Basle Committee on Banking Supervision (1998) at p. 6-7; For an overview of

prevalent, particularly the trading arms of banks, because arrangements for the segregation of duties in trading or funding activities are inadequate.[43] The sophisticated prudential-supervision styles in existence can serve only a limited purpose, that of cushion and/or guide in helping a regulator oversee the various activities of an authorised institution and to reduce the likelihood that problems will affect it severely.

In UK banking supervision, the importance of internal controls was more appreciated with the failure of Johnson Matthey's Bank. Furthermore, new policies enhancing corporate governance within deposit-taking institutions were introduced by the 1987 Act Criteria for Minimum Authorisation (Criteria). The Criteria provided a basis for assessing compliance. Moreover, delays, inaccuracy of information or non-disclosure brings critical scrutiny also upon the deposit-taking business.[44] These provisions complemented the wider prudential requirements of authorisation. Schedule 3 paragraphs 4(7) and (8) of the 1987 Act introduced a requirement for an institution to maintain prudently accounting and other systems of control.[45]

The provision was succinct yet its scope was wide, providing the FSA with the power to assess not only how an authorised institution controls its business but also the adequacy of its systems of control and records. The importance of internal controls is an integral part of the risk-based approach to supervision, the objective of which is to determine the adequacy of the internal-control framework.[46] The risk-based approach, as shown in Chapter Three, attempts to structure and avoid arbitrary supervisory decision-making by elaborating on the ways of assessing the 'fit for purpose' condition of internal controls. While the standard of assessment is identified, it is unfortunate that the Paper does not define 'fit for purpose'.[47] Broader guidance was given in the Statement of Principle for determining the adequacy of internal controls. In order to determine sufficiency of compliance, the FSA considered the size, nature, organisation's structure, volume and complexity of a business by

the Framework, see D Singh, 'Framework for internal control systems in banking organisations', Vol. 5, No. 9, *European Financial Services Law*, (1998) 204-208

[43] GAO, *Foreign Banks: Internal Control and Audit Weaknesses in U.S. Branches*, Washington DC, General Accounting Office September (1997) GAO/GGD-97-181

[44] Banking Act 1987 (1987 Act) s. 36-40

[45] FSA, *Statements of Principles: Issued in accordance with the Banking Act 1987 and the Banking Coordination (Second Council Directive) Regulations 1992*, London, FSA July (1998), para., 2.28

[46] SUP 1.3.1G; and FSA, *Risk based approach to supervision of banks*, June (1998)

[47] Ibid., at p. 40

focusing on the institution under examination rather than on some form of objective test of adequacy. The FSA was required to exercise its discretion when determining whether its internal controls allow an institution's management to direct that institution 'properly' and 'prudently'. The Statement of Principles also required the FSA to take into account an institution's extra-national operations and their internal controls so that the effectiveness of supervision is assessed on a consolidated basis.

The new approach places the importance of control systems and risk management into the meaning-range of 'reasonable care'. Principle 3 provides that 'a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems'.[48] Through it, the FSA gained the power to insist upon the necessity of some form of internal-control and risk management system in every authorised institution by outlining to each its statutory obligation to have one. This obligation seemed to reach beyond the minimum-criteria requirements because it added 'legal certainty' to 'necessary care' required of authorised institutions[49] other than prudence.[50] However, from the analysis of the meaning of 'prudence', one can see that 'prudence' is entailed in 'reasonable care'.

To determine whether an authorised institution has breached the standard of care requirements is by no means easy because subjective criteria necessarily intrude into attempts at objective tests of legality. That a behaviour, was consistent with the standards of 'reasonable care' is determined by whether the party under scrutiny acted as a reasonable man would have acted in a comparable circumstance.[51] Mere error of judgement does not constitute a breach of the duty of care,[52] the exception being an act in departure from general practice.[53] 'General practicc' is the typical behaviour of a skilled man exercising and professing to have a special skill, or of whom it is professed by a body of opinion that he has that special skill.[54] The individual need not

[48] PRIN 2.1.1R. See SYSC for further guidance (*Senior Management Arrangements, Systems and Controls)*; IPRU AR: Accounting and other Records and Internal Control Systems; and *Consultation Paper 35*, London, Financial Services Authority (1999)
[49] 1987 Act sch., 3, para., 4(7) and (8)
[50] Chapter 3 Legal Aspects of Prudential Supervision at p. 68
[51] *Blyth v The Company of Proprietors of the Birmingham Waterworks* (1856) 11 Ex 781
[52] *Marshall v Osmond* [1983] QB 1034 at p. 1038; and also *Whitehouse v. Jordan* [1981] WLR 246 at p. 263, establishes a narrower rule: "it is an error that such a man, acting with ordinary care, might have made, then it is not negligent."
[53] *Kraji v. McGrath* [1986] 1 All ER 54 at p. 61
[54] *Bolam v Friern Management Committee* [1957] 2 All ER 118 at p. 122

have a high level of skill to avoid liability.[55] His act would need to be considered by a professional body or by some other expert opinion in order to determine whether it is an act in departure from general practice.[56]

The courts need also to determine the levels risk of loss or loss by damage.[57] It is held that the mere predictability of harm is not sufficient to identify a breach of duty; one needs to focus on whether an action was unreasonable. The courts would need to consider the likelihood of the risk occurring to determine whether a reasonable man would have attempted to avoid creating the risk.[58] Finally, the court would need to determine the precautionary measures that a reasonable and prudent man would take in the circumstances. According to Denning LJ:

> "*In every case of foreseeable risk it is a matter of balancing the risk against the measures necessary to eliminate it. It is only negligence if, on balance, the defendants did something which they ought not to have done or omitted to do something which they ought to have done.*"[59]

A defendant's activities need to be considered to determine whether precautionary steps would have been apparent to a person of his skills, and that those precautionary steps were such that their taking would have averted the damaging consequences of his activities, and whether the taking of those precautionary steps would have outweighed the costs consequent upon his not taking them.[60]

### 4.4 Corporate Governance and Internal Audit

A particular aspect of internal governance, which has grown in prominence is the role of the internal audit, and under the FSMA 2000, this role is deemed a controlled function.[61] The role of the internal auditor has traditionally been seen as complementary to the statutory audit pursuant of the Companies Act 1985.[62] While this remains the case, the internal audit function has developed as a crucial part of

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[55] *Corporation of Glasgow v Muir* [1943] 2 All ER 44 at p. 47
[56] *Bolam* [1957] op. cit., n. 54, at p. 122
[57] *Bolton v Stone and others* [1951] 1 All ER 1078 at p. 1081
[58] Ibid., at p. 1083
[59] *Latimer v AEC Ltd* [1952] 1 All ER 1302 at p. 1305
[60] Ibid., at p. 1306
[61] SUP 10.4.5R (*Systems and Controls function*) and further guidance is given in IPRU AR 3.3.9 at p. 15. See generally: C Scott, *Internal Audit in a Central Bank, Handbooks in Central Banking, No.4*, London, Bank of England, Centre for Central Banking Studies (1996); The Institute of Internal Auditors – UK http://www.iia.org.uk/about/whatis.html
[62] Chapter 5, The Role of Auditors and Reporting Accountants in Banking Supervision at p. 243

management control.[63] The internal-audit function evolved in the US amongst the American Industrialists, who were deemed the first to have realised its potential. Until recently the internal audit had not gained much attention in UK banking-supervision. This was somewhat unfortunate because the function can assist regulators in the regulation and supervision of authorised institutions. According to the Basel Paper,[64] an internal-audit department that functions in accordance with the Paper's principles facilitates the work of bank supervisors.[65] This is in line with the Cadbury Report on the use of internal auditors.[66]

The internal-audit function can offer a valuable contribution to corporate governance, provided it is given appropriate recognition by an organisation. The traditional function of the internal audit was the detection of fraud and checking of accounting records. However, it has broadened its role to include 'surveying, investigating and appraising the design and operation of the organisational methods, procedures and techniques'.[67] This broadened role potentially provides great assistance to management's efforts at ensuring effective internal controls, wherein the internal auditor acts not only as the architect of internal controls but also identifies where changes are needed in the process of investigation and appraisal. While the internal auditor can identify and bring areas of concern to the attention of management, ultimately management will need to take action, and this is where the problems can manifest as management's indifference to internal-control failures.

Internal audit does not have a statutory basis to determine its terms and conditions. Assistance is provided by the Auditing Practice Board [APB] Guideline. The APB Guidelines take a normative stance and this has resulted in ambiguity. The guidance declares that:

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[63] ICAEW, Internal Audit and its Value – Part 1, London, Audit Faculty, November (1996). http://www.icaew.co.uk/depts/td/tdaf/audit/iav.html
ICAEW, Internal Audit and its Value – Part 2 Internal Control, London Audit Facility, November (1996). http://www.icaew.co.uk/depts/td/tdaf/audit/iav2.html

[64] Basel Committee on Banking Supervision, *Internal audit in banking organisations and the relationship of the supervisory authorities with internal and external auditors*, Basle, Basel Committee on Banking Supervision July (2000)

[65] Ibid., at p. 1

[66] Cadbury Committee, (1992) op. cit., n. 20, at para., 4.39

[67] Management Accounting Committee, *The Modern Approach to Internal Auditing*, London Association of Certified and Corporate Accountants July (1955) at p. 2

*"Internal audit is an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources."*[68]

An important attribute of the internal-audit function is that it is an independent appraisal-method established by management. The notion 'audit function' set up by management' might seem somewhat paradoxical and even dubious. Independence is an essential charateristic of auditing function and serves the legitimate interests of the parties involved. Notwithstanding these broad concerns, the internal audit function is required to be objective in its evaluation and to report on the adequacy of internal controls. Interestingly, while the traditional notion left out values such as 'efficiency' and 'the effective use of resources', these values are integrated into the APB Guidelines. This means that when one is considering the independence and objectivity of the internal-audit function, the inherent limitations of its capacity must be kept in mind to avoid a greater expectation of its objectivity than is reasonably to be expected. The Guideline provides criteria for assessing the effectiveness and efficiency of internal-audit procedures.[69]

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[68] Auditing Practices Board, *Guidance for internal auditors* [AG 308] London APB (*issued June 1990*)

[69] The essentials for effective internal auditing are:

(a) *independence*

The internal auditor should have the independence in terms of organisational status and personal objectivity which permits the proper performance of his duties

(b) *staffing and training*

The internal audit unit should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfil all his responsibilities and objectives.

(c) *relationships*

The internal auditor should seek to foster constructive working relationships and mutual understanding with management, with external auditors, with any other review agencies and where one exists, with the audit committee.

(d) *due care*

The internal auditor should exercise due care in fulfilling his responsibilities.

(e) *planning, controlling and recording*

The internal auditor should adequately plan, control and record his work.

(f) *evaluation of the internal control system*

The internal auditor should identify and evaluate the organisation's internal control system as a basis for reporting upon its adequacy and effectiveness.

(g) *evidence*

The internal auditor should obtain sufficient, relevant and reliable evidence on which to base reasonable conclusions and recommendations.

(h) *reporting and follow-up*

The internal auditor should ensure that findings, conclusions and recommendations arising from each internal audit assignment are communicated promptly to the appropriate level of management and he should actively seek a response. He should ensure that arrangements are made to follow up audit recommendations to monitor what action has been taken on them.

The standards that govern internal-audit procedure are similar to those governing external audit procedure. The statutorily regulated external auditor is required to give an independent view of the financial accounts and the stewardship of a company. Although the Guidelines advise that the internal auditor needs to be (and indeed, that he is seen to be) independent, it has no statutory power to enforce its recommendation. The Guidelines are vague on how management should set up the conditions for independence. The status of external auditor is high profile, given its general powers and rights of communication with all senior management, chief executives, board of directors and the audit committee. The onus for ensuring objectivity is on the internal auditor, which implies that he is his own master. This raises the concern that the internal-audit role could function in a vacuum unless the appropriate status is given it. The guidelines recommend that the auditor should have an objective attitude and remain in an independent position to avoid conflict of interest, so that he is able to exercise judgement, express opinions and present recommendations with impartiality. The auditor needs to avoid in general terms, undue influence, and all factors that can affect his objectivity and consequently undermine the value of his work. An unfortunate weakness of the Guidance is that the internal auditor is, unlike its external counterpart, not required to exercise professional scepticism. While this demand upon the external auditor remains the subject of criticism, the internal auditor can be at ease in his work, and consequently, be effective and valuable.[70]

Like an external auditor, an internal auditor is required to plan, control, record and evaluate not only his findings but also the quality of the evidence. The Guidance concedes that the internal auditor cannot give total assurance that control-weaknesses or irregularities do not exist and exercise due care at the same time. In order to exercise due care, the internal auditor is required to have in mind the ethical standards of the accounting profession, such that those standards direct his work. The Guidance isolates the three main activities executed in the course of an auditing assignment, which on completion are evaluated by management. The internal auditor is required also to assess internal controls to determine whether they are functioning in accordance with the objectives of the institution that employs him. To evaluate his findings the internal auditor needs to ensure that his evidence is sound and reliable evidence for claiming that an institution's internal-control system is in the condition he has judged it to be in. A crucial part of the whole process is that:

> "...*appropriate arrangements are made to determine whether action has been taken on internal audit recommendations or that management has understood and assumed the risk of not taking action.*"[71]

The Guidance attempts to elaborate on the way an internal audit should be undertaken. However, an internal audit is as effective as those undertaking it or those implementing its recommendations. The recommendations made by the internal report at Barings Futures (Singapore) Pty Ltd were not implemented.[72] The Barings debacle highlights the crucial role internal auditors can play and the importance which needs to be attached to their role. The questions about the profitability of the proprietary trading were, on the face of it, pertinent in terms of the audit agenda. What is clear is that these questions were not investigated with the due level of professional scepticism, and that reliance rested on the General Manager's description of the trading practices.

The Barings Internal Audit Report provides insight into the way the (so-called) profits were generated, raises a number of issues and makes a number of recommendations.[73] The main issue, that of the non-segregation of Nicholas Leeson's role was identified as requiring rectification by management, but it was not acted upon. The Report, however, did concede that Leeson's input was necessary in the back office, for the lack of experienced staff. The Report is quite clear in its recommendation that other departments should take on the responsibility for verifying the affairs of Barings Singapore, and that its segregation from other staff should be effected. Nevertheless, the internal audit could have assessed the effectiveness of the current arrangements (rather than taking them at face value) to determine whether they were being abused or overridden in some way, and in so doing, discover how Leeson was going about making his exceptional profits. Moreover, the internal auditor would have needed to implement appropriate arrangements to ensure that management had undertaken what they proposed to do. It is, however, uncertain

[70] For analysis of the relationship between the external auditor and internal auditor, see: Chapter 6 The Role of Auditors and Reporting Accountants at p. 243

[71] APB, *Internal Auditors* (1990) op. cit., para., 18

[72] Schedule 2 'Internal Audit Report', *Re Barings Plc and others (No. 5),* [1999] op. cit., n. 41, at p. 603-613

[73] *Re Barings* [1999] op. cit., n. 41, at p. 609-613

whether they had the time to follow up the recommendations and assess whether they were implemented. Had the funding arrangements been effectively scrutinised in light of the trading limits, rather than focusing on the appropriate ways of funding the activities, then serious anomalies would have been identified. The internal-audit recommendation that an independent Risk and Compliance Officer was required highlights what occurs when a recommendation is unpalatable to management. On reflection, had an independent Risk and Compliance Officer been present, the conflicts of interest that arose from the affair may not have led to the failure of Barings. This attests that recommendations need to be monitored to make sure that if overridden an audit committee or other risk-assessing committee effectively vets them.

The Basel Paper (Principle 4-12) endorses the Guidelines of the Auditing Practices Board in the matter of independence, and impartiality of internal auditors' work. In Principle 4, the Basel Paper notes that the internal-audit function should be a permanent part of banks' organisational structure, rather than a service summoned 'on need', in the way that 1987 Act had allowed. The distinction between the two approaches to the internal-audit function is that the former notes its integral part in banking organisations, whereas the latter simply recognises its occasional necessity. The Principles identify the benefits of the internal-audit function in the work of supervisors[74] and suggest that the co-operation between supervisors and internal and external auditors is the synergy that effects good supervision.[75]

### 4.5 Corporate Governance and The Audit Committee

The audit committee is an established part of the corporate governance of listed companies in the UK[76]. The Bank encouraged the establishment of audit committees long before the Cadbury Committee, and in particular, the introduction of non-executive directors, whose importance had grown in proportion with the importance attached to accountability. It is generally accepted that the New York Stock Exchange made the establishment of an audit committee a listing requirement

[74] Basel, *Internal Audit*, (2000), op. cit., n. 64 at principle 13-18

[75] See Chapter 6 The Role of Auditors and Reporting Accountants at p. 273

[76] C C Verschoor, 'UK Expands Role of Audit Committees: Echoing Treadway Commission recommendations, the British issue a Code of Best Practice', December, *Management Accounting*, (1993), 44-47; R Buckley, *Audit Committees: their role in UK companies*, London, Auditing Practices Committee of the Consultative Committee of Accountancy Bodies (1979); The Institute of Internal Auditors UK, *Audit Committees of the Board, Professional Briefing Note Four*, London IIA UK (1994)

in 1978. However, the initial endorsement for the establishment of audit committees came much earlier, from the decision in *McKesson & Robbins*.[77] That decision noted that to protect the independence of the auditor a 'special committee of the board composed of directors who are not officers of the company appears desirable'. Building on this, the SEC recommended that such committees should also arrange the audit engagement.[78] In the UK there was a similar approach to the evaluation of audit engagement, but its scope was limited to determining whether directors discharge their statutory duty in the matter of financial statements.[79]

The audit committee has a strategic position within an organisation and it is important for an organisation to consider, whether its duties should be broad or specific to the annual financial report. To determine an audit committee's effectiveness, it is important to take into account its formal constitution and the authority it has in an organisation. The traditional practice is that an audit committee acts on behalf of a board of directors to provide 'added assurance' and credibility to that board's financial report to shareholders. By demonstrating that it had exercised care, skill and diligence as prescribed by the law in producing the report. A similar approach was espoused by the Cadbury Committee which recommended that the audit committee oversee directors' preparation of reports.

The audit committee fulfils other crucial roles in the broader audit process. In particular, it provides the starting-point that allows non-executive directors to develop greater insight into a company's financial affairs. Consequently, it enables them to be more effective in their role as non-executive directors. The audit committee provides for the audit-function's independence by dealing with audit matters on behalf of the board of directors,[80] providing a channel of communication between auditor and board. An integral part to the function of the audit committee is to ensure the effectiveness of the internal audit. It is generally advocated that the head of internal audit should have direct access to the chief executive and the audit committee. The audit committee should be able to review internal-audit programmes and the results of audit assignments. In such circumstances an audit committee can enhance the effectiveness of non-executive directors and improve the quality of financial and

[77] *United States v McKesson & Robbins*, 351 US 305 (1987)
[78] Accountants International Study Group, *Audit Committees*, AISG January, (1977) at para., 12-13
[79] Ibid., at para., 19-21 and 24
[80] See generally, Chapter 6 The Role of Auditors and Reporting Accountants

internal controls by providing their independent and experienced views on such matters. While the general purpose of an audit committee may seem to be a panacea for incompetence in accountability, it is reasonable to argue that an audit committee is only as effective as the reliance placed on it an organisation. Therefore, a regulator needs to consider whether the audit committee is a strategic component of an organisation instead of simply check whether or not one exists.

A large amount of empirical work has been done on investigating the effectiveness of the role of audit committees. The findings are inconclusive. Yet there are a number of reasons for forming audit committees, and reasons for the voluntary formation of audit committees differ from jurisdiction to jurisdiction. For example, in the US there has been a strong move towards their formation. A major cause of this seems to have been persuasion by political pressure.[81] According to Menon and Williams, the greater the proportion of non-executive directors on a board of directors the more frequently the audit committee meets, and consequently, there is an increase of reliance on the committee.[82] The frequency with which audit committees meet seems to be important in determining whether reliance is placed on their work, because it shows that the committee intends to be informed and vigilant about a company's affairs.[83] More importantly, McMullens has suggested that the existence of audit committees reduces incidences of error, irregularity and of other accidents that produce unreliable financial reporting.[84] His study showed that where there is an audit committee there are fewer lawsuits by shareholder alleging fraud.

According to a GAO Report, the effectiveness of audit committees in banking institutions is considerable when they are allowed the appropriate level of independence and have the experience/expertise necessary for thoroughly monitoring

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[81] M E Bradbury, 'The Incentives for Voluntary Audit Committee Formation', 9, *Journal of Accounting and Public Policy*, 9, (1990), 19-36; K Pincus et al, 'Voluntary Formation of Corporate Audit Committees Among NASDAQ Firms', 8, *Journal of Accounting and Public Policy*, (1989) 239-265

[82] K Menon & J D Williams, 'The Use of Audit Committees for Monitoring', 13, *Journal of Accounting and Public Policy*, (1994), 121-139; J W Eichenseher & D Shields, 'Corporate Director Liability and Monitoring Preferences', 4, *Journal of Accounting and Public Policy*, (1985), 13-31; and D P Scarbrough et al, 'Audit Committee Composition and Interaction with Internal Auditing: Canadian Evidence', Vol.12, No.1 *Accounting Horizons*, (1998), 51-62

[83] A Dorothy, *et. al*, 'Enhancing Audit Committee Effectiveness', August, *Journal of Accountancy*, (1996), 79-81

[84] D A McMullen, 'Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees', Vol. 15, No. 1, Spring, *Auditing: A Journal of Practice and Theory*, (1996) 87-103

the all the aspects of banking business.[85] The Basel Paper also proposes the permanent creation of audit committees to improve the adequacy of internal controls and internal audit. Under the 1987 Act, authorised institutions in the UK were required to set up audit committees[86]. The Basel Paper goes beyond this and suggests the setting up of audit committees at subsidiaries in other jurisdictions to complement the work of the regulator, internal auditor and external auditor. The FSA, under the FSMA 2000, retains the policy of having a single audit-committee in an institution. This limits the effectiveness of their contribution to the regulation of the institutions extra-national activities. The conclusion is that emphasis should be placed on audit committees as assistants of the regulator. By looking beyond audit committees' external constitutions and how pro-active they are at voicing critical appraisal.

### 4.6 The Board of Directors and Senior Management – Corporate Governance

In this section the role of senior management in corporate governance is given attention and its role is discussed under three sub-headings: a) The Directors' Office governed by the Companies Act 1985; b) The Directors' Office governed by the Banking Act 1987; and c) The Legal Duty of Directors.[87]

Aspects of corporate governance are enforced through the Companies Act 1985 which regulates the internal and external function of a company. A company acquires a separate legal personality once it is incorporated and is deemed a body corporate.[88] This has been interpreted to mean that a company is an independent person in the famous case of *Saloman v Saloman.*[89] The question of directors hiding behind the corporate veil is not so problematic in the regulatory sense as it is in the commercial sense because of the specific gateways opened in prudential supervision,[90] and responsibilities of directors and senior management.[91] Directors' duties need to be considered in the context of this artificial person. The fact that company directors have, in the regulatory order, extra-regulatory duties and responsibilities means they

[85] GAO, *Audit Committees: Legislation Needed to Strengthen Bank Oversight*, Washington DC General Accounting Office (1991)
[86] For further examination on audit committees see Chapter 6 The Role of Auditors and Reporting Accountants
[87] FSA, Statement of Principles July (1998) op. cit., n. 45
[88] Companies Act 1985 s.13(1)-(3)
[89] Saloman v A Saloman & Co Ltd [1897] AC 22 at p.30-31; Lord Templeman, , ''Unyielding rock', ('Forty years on')', Vol. 11, No. 10, *Company Lawyer*, (1990)
[90] See Chapter 3 Legal Aspects of Prudential Supervision at p. 86

are subject not only to company law but also to regulatory requirements, and that their non-compliance with either may constitute civil and criminal offence.[92] It is necessary to rely on common law for clarifying some of the issues in the regulatory order in banking supervision that concern directors and senior management,[93] and upon the proposals of the FSA in its Approved Person Regime.[94] By analysing some case-law developments in common law to see if they shed light on directors' responsibilities in authorised institutions.

### 4.6.1 The Directors' Office under the Companies Act 1985

The general powers of directors are outlined in Table A, art. 70, which states that directors' powers are governed by the Act, the memorandum and articles. This article enables directors to exercise all the powers of a company in the course of managing a business. Hence their position in a company is of considerable importance. In general terms, the director holds office in the company and is its director *de jure*. (The Companies Act 1985 does not distinguish between the various directors).[95] A person who is formally the director *de jure* for the purpose of s. 741(1) of the Companies Act 1985 is responsible for the governance of a company.[96]

The notion 'director' has sub-categories such as 'managing director' - a full-time employee on whom the board of directors confers part or all the powers of management. The board of directors has authority to confer any powers it wishes to confer upon this office, and to impose conditions upon the exercising of those powers.[97] This article of Table A of the Companies Act 1985 and the courts provide only limited clarification of the role of managing director. In the view of Cozens-Hardy J, this level of directorship is distinct from an ordinary directorship because special powers are vested in it.[98] But Earl Jowitt J[99] in *Harold Holdsworth* treated

[91] For consideration of this point see, A Page, 'The State and Corporate Groups in the United Kingdom', p. 111 in C M Schmitthoff and F Wooldridge, *Groups of Companies*. London, Sweet & Maxwell (1991)
[92] For an examination of whether offences under the Companies Act 1985 and regulatory offences can be attached to the company or the directors see: J Gray, 'Company directors and ignorance of the law', Vol. 17, No. 10, *Company Lawyer*, (1996) 296-300
[93] FSA, Statement of Principles, July 1998, op. cit., n. 45
[94] FSA, *The Regulation of Approved Persons: Controlled Functions, Consultation Paper 53*, June (2000)
[95] S. 741 (1) In this Act, "'director' includes any person occupying the position of director, by whatever name called. Companies Act 1985
[96] *Secretary of State v. Tjolle* [1998] BCC 282 at p. 290
[97] *Thomas Logan Ltd v Davis* (1911) Vol. 104 The Law Times Reports 914 at p. 916
[98] *Re Newspaper Proprietary Syndicate Ltd* [1900] 2 Ch 349 at p. 350
[99] *Harold Holdsworth & Co. (Wakefield) Ltd v Caddies* [1955] 1 WLR 352

'managing director' as an office without specific duties. In his view, the powers and responsibilities of a managing director are 'powers and responsibilities' only inasmuch as they are conferred upon a person by a board of directors, as they see fit.[100] Thus the title 'managing director' makes only commercial, not legal, sense.[101] The modern sense of 'managing director' that he provided departs significantly from the one that had become traditional in the sense that Earl Jowitt J had provided.

### 4.6.2 The Office of Director and the Banking Act 1987

The 1987 Act provided a broad vetting procedure for distinguishing 'director', 'controller', 'manager' and 'associate'.[102] To specify the meaning of these appellations more closely and to outline the expectations in the regulatory order of individuals who wear them as titles, one must investigate: the s.16 Statement of Principles, the Guide to Banking Supervision,[103] the common law and the current corporate-governance debate. The 1987 Act defined 'director' on lines similar to the common-law interpretation of the position within the company. The Guide identifies the director as an individual who is part of the board of directors, thus including 'chairman' in the identification. Whether the director holds an executive position is irrelevant, here. In the case of an overseas institution, attention is given to those in the following positions: chairman, chief executive and any managing board member. There is a general definition in s. 105(6) and (7) respectively of 'manager' and 'chief executive' these simply note that a manager acts on behalf of a director or chief executive and a chief executive acts on behalf of the directors.

The Statement of Principles focused on directors, chief executives, managing directors and managers. Whilst it attempted to identify broadly the standard of skill and care required of people in these offices, it did not specify the expectations of office holders. So although there are practical distinctions in the roles of director and managing director/executive director, in law, the duties of these officers are delineated only by their individual contracts of service. However, there is parity in the way boards of directors envisage directors' duties.[104] It was obligatory that an authorised institution be directed by at least two managing directors. This is the

100 Ibid., at p. 356
101 *Tjolle* [1998] op. cit., n.96, at p. 290-291
102 1987 Act s. 105
103 FSA, *The FSA's Approach to the Fit and Proper Criterion*, GN-FP: Section 2-3, para, 3.4 key definitions: director, controller and manager, (Date Issued 31.12.99) at p. 3
104 The Cadbury Committee, (1992) op. cit., n. 19, at para., 4.3

presumption of the 'four eyes principle' in activities that inform the formation and implementation of company policies and the effective direction of the company. This principle is one of substance rather than form, and focuses on the activities and conduct of managing directors.[105] Its objective is to ensure that at least two parties are able to monitor the proceedings of board meetings and eradicate wayward influences that threaten to become dominant. Two directors need to play an important part in 'all significant decisions' of the board. Unfortunately, the Statement of Principles did not define 'significant decision', therefore it was left to the discretion of the FSA to assess the activities of not only the board but also of the role of managing directors and their board undertakings. According to the Statement of Principles, managing directors must be involved in all decisions:

> "*Both individuals' judgements must be engaged so that major errors leading to difficulties for the institution are less likely to occur. Similarly, each individual must have sufficient experience and knowledge of the business and the necessary personal qualities and skills to detect and resist any imprudence, dishonesty or other irregularities by the other individual.*"[106]

The Statement of Principles added little light to the function of the board.[107] This is unfortunate considering, the importance of the board of directors in terms of strategic decision-making. The Barings debacle is evidence of where this can lead when boardrooms have limited understanding of business activities.[108] It would have been more useful to provide some guidelines on how the board of an authorised institution should function in terms of the vigilance required at this level.

Some light is provided by the Cadbury Code, which suggests that the effectiveness of the board should be assessed on the way it works collectively to meet its obligations.[109] This assessment is to be of the contribution made by executive directors who are deemed to have an intimate knowledge of a business. However, such an assessment can be cogent only if the activities both of the board and of personnel in subsidiaries and international branches are scrutinised. The number of directorships is an issue in how many an individual director should have. For

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[105] *R v Bank of England (ex parte Mellstrom) QBD 1995*. This is notwithstanding the fact that in the present case the Bank found no evidence that the 'four eyes principle' was breached.
[106] FSA, Statement of Principles (1998) op. cit., n. 45, para., 2.39
[107] FSA, Statement of Principles (1998) op. cit., n. 45, para., 2.40
[108] Treasury Committee House of Commons, *Barings Bank and International Regulation, Minutes of Evidence, Mr Peter Norris and Mr Geoffrey Barnett*, London HMSO Session 1995-96 Monday 10th June (1996) at p. 42 para, 343-350

example, Peter Baring, at the time of the Barings collapse, had a number of directorships. This must surely have undermined his ability to fulfil his regulatory responsibilities. This is an issue that should have been monitored on a continuous basis by the regulator,[110] even though it is difficult to identify how many directorships the director of a regulated institution should have before their number begins to interfere with his ability to perform his regulatory responsibilities. While this suggestion may seem extreme, the repercussions of the failure to attend to this issue is clear in the aftermath of the Barings collapse.

The role of non-executive directors in reviewing the performance of the board and generally enhancing corporate governance was also given considerable prominence in the Cadbury Code.[111] It promoted also the use of sub-committees for audit, remuneration and nominations purposes. Such sub-committees are said to buttress the work of the board. In the Combined Code, the establishment of sub-committees is a formal condition for listing.[112] The revised Statement of Principles simply encourages the setting up of audit committees. This seems unfortunate when one considers the good use that could be made of remuneration and nominations committees in businesses in which bonuses play a large part in motivating executive directors.[113] While there are cost implications in appointing non-executive members to such committees, cost must be balanced against the potential benefits of having them: They are cost-effective for their ability to refine accountability procedures and perform objective scrutiny of board decisions – activities of primary importance since the establishment of audit committees.[114]

**4.6.3 The Legal Duty of Directors**

It is clear that the powers of company directors are both broad and somewhat ambiguous. It is clear also that this situation must be corrected with a precise statement of directors' responsibilities to companies, of companies' general expectations of them, and of the legal footing of those responsibilities and expectations. It is inevitable that the commercial decisions of directors will lead to

[109] Cadbury Committee, (1992) op. cit., n.20, at para., 4.1
[110] Minutes of Evidence Taken before the Treasury Committee Wednesday 15th May 1996 at p. 34 para., 249-264
[111] Cadbury Committee, (1992) op. cit., n.20, para, 4.3-4.6 & 4.10-4.17
[112] Combined Code 15.1.2
[113] FSA, Statement of principles (1998) op. cit., n. 45, at para., 2.40-2.42
[114] FSA, Statement of principles (1998) op. cit., n. 45, at para., 4.3.3

significant risks that can, on occasion, call into question a company's viability,[115] hence the general duty to exercise due skill and care in decision making. The nature of this general duty becomes more complex for companies (such as banks) that operate in the regulated sector. These institutions are obliged to meet high levels of public expectation and to promote the interests of depositors. Surprisingly the majority of the institutions that have been in the forefront of change in the corporate governance area are high-profile regulated institutions such as BCCI, Maxwell, Barings and a host of others. This highlights the importance of examining the parallel between 'the general duty to exercise due skill and care in decision making and the duties imposed by the regulatory order. This examination should extend to determine whether company legislation makes the responsibilities of regulated institutions more onerous.

The strong assumption is that an authorised institution in the regulated sector must remain an autonomous body with an unfettered 'entrepreneurial spirit'. However, when in the regulators opinion the 'entrepreneurial spirit' clashes with supervisory objectives such as depositor protection, then the regulator can exercise his powers to curtail the operations of the authorised institution, and in some respects, override its business judgement. This is illustrated by the events related in the course of the unsuccessful 'misfeasance in public office' action in *Hall v Bank of England*.[116] The Bank brought the action pursuant of s.13 of the Banking Act 1987 to challenge the propriety of investments in cheap housing by the Hall family's authorised deposit-taking business. However, despite the failure of the court action, the Bank exercised its powers to restrict the activities of the Hall business, thus enforcing the sale of its unoccupied properties, and in view of its prudential failures, demanded changes to its management structure.[117] This case reveals the reach of regulatory power and its resources for taking extra-judicial remedial action to override the judgement of those in control of a business.

The standard of care and skill required of a director is a difficult issue to address, given the nature of the general office and the lack of clarity in the articles of association governing this office. Case law has developed the fundamental principles

[115] V Finch, 'Company Directors: Who Cares About Skill and Care?', Vol. 55, March, *Modern Law Review* (1992), 179-214 C A Riley, 'The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard', Vol. 62, September, *Modern Law Review* (1999), 697-724
[116] Unreported Court of Appeal Decision, *Hall v Bank of England* Wednesday 19th April 2000 CHANI 1999/0854/A3 CH 1997 H 544
[117] Ibid., at p. 8

that underpin the responsibilities of directors and the duty they owe to a company.[118] The standard- of-care that those duties and responsibilities entail was outlined by two key decisions: *Re Brazilian Rubber Plantation*[119] and *Re City Equitable Fire Insurance.*[120] These decisions are considered to be 'of their time'. However, some of their salient features remain relevant today, among them the difficulty of establishing standard-of-care requirements,[121] because, provided that directors act honestly and with due care and skill, they cannot be held responsible in tort for damages. According to Romer J, it is necessary to consider a company's business to determine the actual duties of a director. One needs also to consider the way company responsibilities are shared by directors and the other officials. Romer J shows that a holistic approach is required to identify the responsibilities of directors. Such an approach requires an understanding of how a company arranges its affairs, to whom functions are delegated, and who the delegator is. The 'due care and skill' duty is to depositors and investors, but the issue of whether that duty can be compartmentalised in percentage terms remains unresolved. The required standard in performance is 'reasonable care', and is determined in terms of the profession's assessment of competent persons' capacity for performance.[122] Thus the director who holds office in a company and knows its business is required to use his knowledge in the interest of that company's business.[123] In his first proposition, Romer J in *Re City Equitable Insurance*, supports this principle.

> "*A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.*"[124]

This proposition provided a controversial illumination of 'general duty'. In particular, its inherent 'standard of care' and skills required' standards were considered to have been set too low to adequately reflect what is expected of directors today. On those standards, an ignorant director acting honestly on his own knowledge and experience would be deemed to have acted with the due skill and care. If directors do not have the necessary specialist knowledge of the business then they are judged

118 *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145
119 *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425
120 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407
121 M J Trebilcock, 'The liability of Company Directors for Negligence', Vol. 32, *Modern Law Review*, 499-515
122 *Bolam* [1957] op. cit., 54, at p. 122
123 *Re Brazilian Rubber Plantation* [1911] op. cit., n. 119, at p. 437

accordingly. The standard provided in *Re City Equitable Insurance* builds upon the objective standard set in *Re Brazilian Rubber Plantation.* That objective test is additional to the three propositions so it cannot simply be negated. It is not directly a subjective test based on the individual's own knowledge and experience. Skill is also necessary, which is considered in the context of the company/business: for example, the director of an insurance company may not have the skills of an actuary.

The modern authority of cases such as *Dorchester Finance Co*[125] have not lost sight of the standard set by Romer J, but the test is now supplemented by an overtly objective test of when duty is carried out with:

> "*[S]uch care as an ordinary man might be expected to take on his own behalf and must exercise any power vested in him in good faith and in the interests of the company.*"[126]

A further development of the 'standard of care' concept, and in particular, the articulation of the subjective and objective components of the test for assessing company directors, came from Hoffman J (as he then was). Section 214(4) of the Insolvency Act 1986 was deemed to contain the relevant articulation of the standard for judging the acts and omissions of directors.[127] This was re-affirmed by Hoffman J in *D'Jan*:

> "*[A] reasonably diligent person having both – (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has.*"[128]

The test highlighted by Hoffman J is very similar to that advocated by Foster J in *Dorchester Finance Co*, in that both tests clearly consists of a subjective and an objective element.[129] The first test to be satisfied, whether the director was a 'reasonably diligent person', is to show that the knowledge, skill and experience he has is equivalent to that of a director in a similar position. Therefore, a finance director would be assessed in terms of a reasonably diligent finance director, not of a

124 *Re City Equitable* [1925] op. cit., n.120, at p. 408
125 *Dorchester Finance Co Ltd and another v Stebbing and others* [1989] BCLC 498
126 Ibid., at p. 498
127 *Norman and another v Theodore Goddard (a firm) and others (Quirk third party)* [1991] BCLC 1028 at p. 1031
128 *Re D'Jan of London Ltd Copp v D'Jan* [1994] BCLC 561 at p. 563

sales director. However, subjective elements still require consideration within this objective test in sub-section (b) of s. 214(4). While the standard provided is succinct, the salient feature of *Re City Equitable Fire Insurance* will nevertheless continue to be valid in terms of factors to be considered. Some of these factors are:

(i) the complexity of the business;
(ii) the number of times a director attends meetings;
(iii) judging like with like and not even compare directors in different departments with each other;
(iv) not to compare directors of a large company with those of a small company;
(v) the way the work in a company is distributed;
(vi) distrust of co-directors.[130]

These factors will inevitably be considered when the standard set out in s.214(4) is applied.

From the above it is clear that numerous factors are considered to determine whether a director meets the standard of a reasonably diligent person. The need to clarify the standard is obvious in the growing complexity of business. In the regulation of an authorised institution, individuals in the position of director and senior management, as identified above, are required to be 'fit and proper'. This is to be so even before they enter the business of deposit-taking. Directors responsible for deposit-taking institutions were required to comply continuously with the standard-of care-monitored by the FSA.[131] To determine whether an individual in the above capacity is 'fit and proper', the FSA considered a number of factors that required analysis of these requisite parts, so that they can be interpreted in light of relevant case law.

[129] A Hicks, 'Directors' Liability for Management Errors', Vol. 110, *The Law Quarterly Review*, (1994) 390-393
[130] *Re City Equitable* [1925] op. cit., n. 120, at p. 408
[131] FSA, FP: Section 2, 'The FSA's Approach to the Fit and Proper Criterion', (Date Issued 29. 6. 98)

#### 4.6.3.1 Fit and Proper

For a director to be 'fit and proper', that person must be fit and proper to hold a licence and to undertake the business of the licence-holder.[132] The FSA took into account a number of both general and specific considerations as determined by the position held by the director or manager and the institution concerned. Moreover, while this duty was traditionally owed to the company in respect of banking institutions, it would come under scrutiny if the interests of depositors and future depositors were threatened.

#### 4.6.3.2 Diligence

The standard of care and skill required by the FSA from such directorships was that of 'diligence' in accordance with both para. 2 of Schedule 3 of the Banking Act 1987 and para. 2.50 of the revised Statement of Principles. According to Willmer LJ, the obligation to exercise due diligence is indistinguishable from an obligation to exercise reasonable care.[133] Consequently, 'diligence' is determined by the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience that that director has.[134] The FSA attempted to interpret "diligence" more narrowly by referring to the manner in which duties and responsibilities were executed and the time devoted to duties. This could arise from a failure of any of the requisite ingredients of the 'fit and proper' test.[135] The decision by Romer J made it clear that the courts look at directors' commitment to the company liberally, particularly when they fail to attend to company matters. The standard provided in the Statement of Principles is much higher than that proposed by Romer J, even if his comments are now applied only to non-executives.[136]

#### 4.6.3.3 Competent

A further facet of the 'fit and proper' rule provided by the Statement of Principles is the definition of a person's competency, which unfortunately is not defined in para.2 Schedule 3 of the Banking Act 1987, nor in the Statement of

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132 *R v Hyde JJ* (1912) Vol. 106 *The Law Times Reports* 152 at p. 158
133 *Riverstone Meat Co Pty Ltd v Lancashire Shipping Co Ltd* [1960] 1 All ER 193 at p. 219
134 Insolvency Act 1986 s. 214(4)
135 FSA, Statement of Principles, (1998) op. cit., n. 45, at para., 2.50
136 *Re City Equitable* [1925] op. cit., n. 120, at p. 429

Principles. According to Winn J, persons are competent to perform a particular function when on a fair assessment they can reasonably perform a particular function in the light of the factors involved, the problems to be studied and the degree of risk of danger implicit in the task.[137] This interpretation of 'competency' can be complemented by the definition provided by Cantley J, who suggests that it is the virtue of a practical and reasonable man who can look and recognise what to look for.[138] This interpretation sheds light on what to look for when considering an individual's competency with the other aspects of the 'fit and proper' criteria of the Statement of Principles. The FSA took into account also a person's previous experience, track-record, qualifications and training. With regard to 'soundness of judgement', the FSA considered, among other things, the degree of balance, rationality and maturity demonstrated in conduct and decision making.[139]

#### 4.6.3.4 Skill

The Statement of Principles referred firstly to 'sufficient skill, knowledge, and soundness of judgement'. Skill is referred to widely in the standard-of-care, but it has been separately defined from the standard of 'a reasonable diligent person'. The traditional approach adopted by the English courts is that a director needs no special qualifications for his office.[140] However, this is based on the proviso that if the director does have specialist knowledge then he is bound to bring that knowledge to his office. Reference to 'sufficient' suggests that more is required. According to the Oxford dictionary, 'sufficient' means 'good enough, large enough, or powerful enough; adequate enough', and derives from 'sufficiency', which means 'an adequate amount' or 'adequate resources'. The idea of 'skill' is defined by Clarke and Sheller JJA. They suggest that skill is a special level of competency that is distinct from that possessed by a reasonable man, is gained by special training and experience, and is determined by the level of care reasonably expected of a person undertaking particular work.[141] This definition clearly highlights that particular qualities are required and that they are additional to those that a 'ordinary man' would profess to have. The standard of skill called for by the FSA would of been that special skill in the position held. The FSA recognises that a director's responsibilities are relative to the department; the

[137] *Brazier v Skipton Rock Co., Ltd* [1962] 1 All ER 955 at p. 957
[138] *Gibson v Skibs A/S Marina and Orkla Grobe A/B and Smith Coggins, Ltd* [1966] 2 All ER 476 at p. 478
[139] FSA, Statement of Principles (1998) op. cit., n. 45, at para, 2.52
[140] *Re Brazilian Rubber Plantation* [1911] op. cit., n. 119, at p. 437
[141] *Daniels v Anderson* op. cit., n. 40, at p. 667

position held thus conforms to the general rule espoused by Romer J.[142] According to the FSA, 'a person could be fit and proper for one position but not fit and proper for another position involving different responsibilities and duties'.[143] This would clearly be required by a finance director or director of a specialist department (investment banking department) where risks require continuous monitoring. (More importantly, it would call into question when a director with experience in a particular banking sector moved into another, requiring other specialist skills). In such circumstances it would mean the director is expected to have a particular expertise. (That may not necessarily mean he has the skill of a rocket scientist who is putting together a complex Over-the-Counter [OTC] Derivative). The director needs to acquire specialist skills and knowledge to exercise the reasonable care expected of persons undertaking such work, so that they can take reasonable steps to guide and monitor management of the company, the effect of which will benefit the shareholders and members of the company.

#### 4.6.3.5 Probity

The probity of an individual is very important for the purposes of the FSA. Probity refers to an individual's uprightness and honesty. A person's probity is an important characteristic; this is called into question in whatever position he holds in an authorised institution when breach of trust, and level of culpability needs to be determined. According to Gowan J, honesty is equated to acting *bona fide* in the interests of the company, whereas an act in bad faith involves an understanding that what is being done is not in the interests of the company, and is a deliberate conduct in disregard of that knowledge.[144]

#### 4.6.3.6 Reputation and Character

The FSA takes into account a person's reputation and whether the person had a criminal record or has contravened any regulatory requirements. According to Mayo J, reputation is a fact a summation of all the beliefs popularly held about the individual in a community whether positive or negative.[145] Consequently, the FSA had the discretion to delve further than formal records. For example, the FSA would also take into account non-compliance with non-statutory codes of conduct governing the

[142] *Re City Equitable* [1925] op. cit., n. 120, at p. 408
[143] FSA, Statement of Principles (1998) op. cit., n. 45, at para., 2.50
[144] *Marchesi v Barnes* [1970] VR 434 at p. 438
[145] *Dias v O'Sullivan* [1949] ALR 586 at p. 591

wholesale money markets (the London Code of Conduct) and the Joint Money Laundering Steering Group's Guidance Notes, the Code of Banking Practice and the Take-over Code. When considering contraventions, the FSA looks for deceitful, oppressive or improper conduct and any other conduct which may 'reflect discredit on that person's method of conducting business'.[146]

### 4.6.3.7 Isolated or Cumulative Failures

The FSA took a cumulative approach towards regulatory failures rather than taking action against individual incidences that would not necessarily lead to holding a person unfit and improper. This point is supported by the views of Nicholl's V-C in *Re Swift 736 Ltd*, where he strongly emphasises the importance of condoning a blatant disregard of fulfilling-measures to ensure effective accountability, which may not be dishonest or isolated: he suggested that attitudes such as these need to be corrected.[147] The essential ingredient in this form of non-compliance is blatant disregard of such requirements rather than an element of dishonesty. Provisions like these ensure accountability, therefore an accumulation of 'administrative' failures suggests a lack of rigour or discipline.

## 4.7 The FSMA 2000 Approved Person Regime

With the introduction of the FSMA 2000, a new approach is adopted to regulate 'directors' and 'managers'. These individuals could be deemed 'approved persons' if their role within the organisation is considered a 'controlled function'.[148] The functions designated as controlled are those which add value to the regulatory process and will assist the FSA to fulfil its regulatory objectives, therefore no person can exercise a controlled function unless the individual is approved by the FSA under s. 59 of the FSMA 2000.[149] The formalisation of designated 'approved' and 'controlled' functions is based on the more traditional 'fit and proper' requirement to enter a regulated activity. Under the FSMA 2000 those approved would have to fulfil the FSA's 'fit and proper' criteria which has a number of similarities to the previous regime.[150] It is the responsibility of the authorised person, *i.e.* the regulated entity, to ensure that those exercising controlled functions are approved. The introduction of the

146 FSA, Statement of Principles (1998) op. cit., n. 45, at para., 2.53
147 *Secretary of State v Ettinger, Re Swift 736 Ltd* [1993] BCLC 896 at p. 900
148 AUTH 6 and exceptions see AUTH 6.5.1G. See also TC 1 training and competency rules apply to employees responsible for regulated activities.
149 Ibid., 6.2
150 FIT1-2

approved person to the regime will mean that individuals who exercise 'significant influence' will be exposed to a different enforcement procedure with an elaborate array of deterrent strategies more prevalent in the investment business. This will be a huge change from non-transparent enforcement-actions taken against individuals, with the only enforcement- sanction now being the nuclear option of prohibition.[151]

A function is 'controlled' when it fulfils the general conditions of s. 59(5)-(7) of the FSMA 2000. They are: s.59(5) where the individual has significant influence over the conduct of the approved person; s.59(6) where the individual deals with customers; s.59(7) where the individual deals with the property of its customers. The first (1-20) are deemed functions of significant influence: 1-7 relate to the governing body (directors, chief executive officer and non-executive directors); 8-12 govern controlled functions which relate to (money-laundering and reporting-officer) systems-and-control functions; 13-15 govern significant management functions (internal auditor); 16-20 govern investment business.[152] The formalisation of these roles is new. It identifies the parties with a significant control function. For example, the governing body is clearly identified as consisting of individuals who may be designated as having significant influence. This in many ways moves these individuals away from the vagueness of the common-law responsibility of these designated directors by providing a basis upon which particular regulatory expectations can be identified and consequently assessed by referring to their performance. The way to achieve this is to clearly define the duties of the directors and senior management in the regulated sector.

Building on the approved-person regime highlighted above, the FSA has also introduced Seven Principles to govern functions within an organisation.[153] The principles introduced by the FSMA 2000 apply to individuals exercising controlled functions. The Seven Principles equate in many ways to the principles that existed in the Statement of Principles introduced by s. 16 of the Banking Act 1987 and the due care expected under the common law. The way in which these principles equate to those provided under the existing Statement of Principles and the common law is as follows:

[151] Chapter 5, Enforcement Methods and Sanctions in Banking Regulation and Supervision at p. 184
[152] SUP 10.4.5R

Principle 1 focuses on carrying out functions with 'integrity' and in many respects equates with the requirement for probity in the Statement of Principles, hence with the honesty of individuals in the way they exercise their responsibilities. Principle 2 requires that those exercising such functions should act with due skill, care and diligence. This requirement fulfils the pre-requisites of the Statement of Principles in terms of acknowledging the importance of 'skill', 'care' and 'diligence', and equates with the standard-of-care suggested by Hoffman J in *Dorchester Finance* and re-affirmed in *D'Jan*. Principle 3 requires observation with proper standards of market conduct. Again, this is similar to the latter part of para 2.53 of the Statement of Principles, requiring compliance with various codes of conduct, such as the Grey Paper, which operate in the various financial markets. Principle 4 requires the approved person to co-operate with the FSA openly. This in many respects is a central cog in regulation and supervision, and under the 1987 Act would require compliance with a broad range of powers, especially those relating to controllers (s.21-26), information (s.36-40), and investigations (s.41-44). These are also underpinned by the Statement of Principles.

Principles 5-7 relate specifically to those in senior management and performing controlled functions. These Principles require senior management to organise a business so that it can be controlled effectively, to exercise due skill, care and diligence in their management responsibility, and to ensure that the firm they are responsible for complies with the regulatory requirements. These are not necessarily more draconian than the other principles, but recognise that those in senior management have a greater responsibility regarding the affairs of the business, and in general terms equate to para. 2.54 of the Statement of Principles:

> "*...those persons with the main responsibility for the conduct of an institution's affairs, the standards required are particularly high, and will commensurate with the nature and scale of the business concerned.*"[154]

Moreover, the Principles governing senior management are similar to those of the common law. The principles that emanate from the disqualification of the

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[153] APER 2..1.2P
[154] FSA, Statement of Principles, (1998) op. cit., n. 45, at para., 2.54

directors at Barings,[155] complement existing common-law requirements relating to directors of companies and the expectations of those in such positions.

### 4.8 Disqualification Proceedings: Directors of Barings Bank

The collapse of Barings brought into question the responsibilities of executive directors, in particular, their acts or omissions leading to Leeson's unauthorised trading. The investigation of Barings re-affirmed the importance of understanding the responsibilities of businesses directors for effective internal controls, management of risk and communication between head-quarters and branch subsidiaries.

The Treasury Select Committee Report on the Barings debacle focuses on regulatory failures and recommendations for improving regulatory systems, but does not elaborate on measures for guarding against the kinds of management failures that allowed the unauthorised trading to continue.[156] More importantly, the collapse of Barings brought the regulatory enforcement decisions and those that exist under the Companies Director Disqualification Act 1986 (CDDA 1986) into contention. Whilst the Bank was the lead regulator for Barings Brothers Company for prudential purposes, the day-to day supervision and enforcement of the group's investment business this was undertaken by the Securities Futures Association (SFA) for the subsidiaries of Barings. Regulatory enforcement in investment business is based on specific interests and concerns relating to the regulated industry. For example, the reason for enforcement-action in the financial markets is to ensure that directors and other senior management are complying with the SFA rules regarding market confidence, investor protection and prudential supervision. Non-compliance could result in civil punitive sanctions such as suspension, revocation, civil monetary penalties and perhaps criminal sanctions. The CDDA 1986 is much broader, relating to the general duties of directors and compliance with the Companies Act 1985 and the Insolvency Act 1986, potentially leading to disqualification of a director to manage any company.

SFA enforcement proceedings lead to disqualification periods and monetary penalties and criminal sanctions. Many of these powers were exercised against some

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[155] *Re Barings Plc and others (No. 3), Secretary of State for Trade and Industry v Baker and others (No. 3)* [1999] 1 BCLC 226

[156] House of Commons Treasury Committee First Report. *Barings Bank and International Regulation*, Volume I, 12th December (1996)

senior management involved in the Barings debacle because of their involvement in Leeson's unauthorised trading. The case against Ronald Baker, a director of BB & Co (authorised by the SFA) and others brings to the fore the friction, between the general purpose of the SFA regulatory regime and that which exists under the CDDA 1986.[157] This friction was created by their respective decisions on the *prima facie* standard of care evolved within the two regimes. The main allegations against Baker were that he failed to act with *due skill, care and diligence* in terms of his responsibilities for Leeson's switching business, and that he failed to organise and control the affairs of the *Financial* Products Group. The SFA dismissed all the charges against Baker, except the charge of failure to properly monitor the switching business.

The basis for assessing whether a person is 'fit and proper' is deemed distinct, in that its criteria are:

> "*financial integrity and reliability; absence of convictions or civil liabilities; possession of suitable experience and educational or other qualifications; good reputation and character; and efficiency, honesty and fairness.*"

While the court made clear that these criteria are distinct, it did not go into how it is different. Moreover, the question put to the court was different: whether the SFA is an 'emanation of the state'. However, the standard of care which underpins Part 1 Schedule 1 (1) of the CDDA 1986 and the common-law duty of care, consists of both an objective and subjective test of due diligence. This standard of care focuses on the experience and knowledge of, for example, a director of an investment bank as it would apply to a director who is a chartered accountant, in the relative context of their positions. Therefore, although the purpose of both regimes is distinct, the basis of their decisions upon the standard-of-care issue is quite similar in terms of the attributes required: care, skill and diligence, and the way this can be applied. The reasons why the SFA felt that Baker should be exonerated were not considered by the court. The SFA Chairman did point that Mr Baker had rebutted all the charges made against him at the SFA Disciplinary Tribunal.[158] That question would only be determined by an appeal or judicial review of the enforcement decision. What the decision highlights is that the CDDA 1986 is complementary to the common law, focusing on the behaviour of directors which comes when the director's competence,

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[157] *Re Barings Plc (No. 3)* [1999] op. cit., n. 155, at p. 231
[158] SFA, Press Release, R Baker, 11th June 1997 at p. 1

skill or diligence in the management of the company is questioned generally, or when the company goes into insolvency.

### 4.8.1 Disqualification of Company Directors (CDDA 1986)

The general duties of directors, like any duty or responsibility in commercial or regulatory life, require appropriate guidelines and regulatory measures to ensure that they comply with their legal responsibilities. This is to safeguard the privilege of incorporation, and in the regulatory order, to ensure the integrity of the market. The duty discussed above is a broad measure used to ensure compliance which can be utilised when a breach occurs. The CDDA 1986 not only encompasses this form of breach but also other forms of non-compliance linked to the management of a company. The primary purpose of the CDDA 1986 is to protect the public interest and is in addition to its role in enforcing regulatory measures against directors for their wrong doings. Enforcement consists of dismissing directors from office when they are found to be unfit to hold such office. Thus the CDDA 1986 and the regulatory sanctions have a similar public function in terms of protecting society from particular social wrongs, and are therefore *ex ante* measures. This is notwithstanding the fact that the order by the court under the CDDA 1986 and regulatory orders clearly have a punitive effect.[159] The punitive nature of the disqualification measure is elaborated upon by Nicholas Browne-Wilkinson V-C. According to his Lordship:

> "*...the power is not fundamentally penal. But if the power to disqualify is exercised, disqualification does involve a substantial interference with the freedom of the individual.*"[160]

Accordingly, a disqualification is legally deemed penal when it is contravened, but the order itself clearly restricts the liberty of the individual.[161] The measures under the CDDA 1986, built on the punitive civil sanctions, are prevalent in the wider regulatory order.[162] The Secretary of State for Trade and Industry, who is responsible for the operation of the CDDA 1986, brought disqualification proceedings against ten of Barings' directors under s.6, on the power of s.8 of the CDDA 1986.[163] This power

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[159] J Dine, 'Punishing Directors', *Journal of Business Law*, (1994) 325-337; C D Drake, 'Disqualification of Directors – The "Red Card"', *Journal of Business Law*, (1989) 474-491; A Hicks, 'Disqualification of Directors – Forty Years On', *Journal of Business Law*, (1987) 27-48
[160] *Re Lo-Line Electric Motors Ltd & Ors* (1988) 4 BCC 415 at p. 419
[161] *Re Cedec Ltd* [1991] BCC 148 at p. 153
[162] J Dine, 'Punishing Directors', (1994) op. cit., n. 159, at p. 325
[163] See *Re Barings Plc (No. 5)* [1999] op. cit., n. 41, at p. 433 While the disqualification period has not been decided in the cases of Mr Andrew Tuckey, Mr Ronald Baker or Mr Gamby, it has for: Mr Peter

outlines the Secretary's general responsibilities under the Act. According to Woolf MR, Parliament had designated the Secretary of State as the proper public officer to discharge the function of making applications to the court for disqualification orders.

> "*All these litigation decisions are made by the Secretary of State according to what is considered by him/her to be 'expedient in the public interest'. They are not made by the court or by other parties to the proceedings.*"[164]

Case law is more advanced than statutory law in that the courts are supplementing the CDDA 1986 by taking a dynamic and vigorous approach. The principles developed in this area have seeped into the broader area of directors' common-law duties and have consequently raised the standard-of-care expected of directors.

**4.8.1.1 A Disqualification Order**

The power to disqualify a director has the effect of preventing an individual from acting in all capacities as a director. The rule of disqualification in s.1(1) CDDA 1986 provides, *prima facie*, a choice between the capacities in which an individual can be prohibited from performing. It has been decided that an order to disqualify should indicate the full wording of s.1 (1)(a)-(d), rather than a sub-set of its parts.[165] Under s. 1 of the CDDA 1986 may, with the permission of the court, make a disqualification order under section 6: to the effect that a person may not be a director of a company; a liquidator of a company; a receiver or manager of a company's property; or in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company.

Disqualification for conduct deemed unfit for managing an insolvent company is governed by s.6 of the *CDDA* 1986. This requires that the court must be satisfied under s.6(1):

> "*(a) that he is or has been a director of a company which has at any time become insolvent (whether while the person was a director or subsequently); and (b) that his conduct as a director of that company (either taken alone or taken together with the person's conduct as a director of any other company*

Norris (4 years); Mr George Maclean (4 years); Mr Ian Hopkins (5 years); Mr James Bax (4 years); Mr Geoffrey Broadhurst (3 years); Mr Anthony Hawes (5 years) and Ms Mary Walz (2 years)

[164] *Re Atlantic Computers Plc, Secretary of State for Trade and Industry v Ashman* [1998] 1 BCLC 676 at p. 680

[165] See *Re Gower Enterprises Ltd (No2)* [1995] BCC 1081 at p. 1085; reference to parts of s. 1 do not necessarily mean the order is invalid see: *Official Receiver v Hannan* [1997] 2 BCLC 473 at p. 477

*or companies) makes the person unfit to be concerned in the management of a company."*

An order under s.6 is generally for the purpose of protecting the public interest from unfit directors[166]. In the case of s.6, the court is obliged to disqualify a director found to be unfit. The Secretary of State has the power to initiate disqualification proceedings after an official statutory investigation is carried out.[167] Unfitness and disqualification is a special matter and not concerned with the solvency or insolvency of a company.

Section 8 provides a much wider deterrence measure for non-compliant directors than s.6. In order to determine under s.6 or s.8 whether an individual is unfit to be concerned in the management of a company, the court takes into account s.9 of the CDDA 1986. This requires consideration of Part 1, Schedule 1.[168]

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[166] See section 7(1) If it appears to the Secretary of State to be expedient in the public interest that a disqualification order under section 6 should be made against any person, an application for the making of such order against that person may be made:

a) by the Secretary of State; or
b) if the Secretary of State so directs in the case of a person who is or has been a director of a company which is being wound up by the court in England & Wales, by the Official Receiver.

According to Harman J

[167] Ibid., s. 8

[168] Ibid., Sch.1: Part One:

(1) Any misfeasance or breach of any fiduciary or other duty in relation to the company
(2) Any misapplication or retention by the director of, or any conduct by the director giving rise to an obligation to account for, any money or property of the company
(3) The extent of a director's responsibility for the company entering into any transaction liable to be set aside under Part XVI of the Insolvency Act (provisions against debt avoidance).
(4) The extent of a director's responsibility for any failure by the company to comply with any of the following provisions of the Companies Act 1985, namely
    (a) section 221 (companies to keep accounting records);
    (b) section 222 (where and for how long records are to be kept);
    (c) section 228 (register of directors and secretaries);
    (d) section 352 (obligation to keep and enter up register of members);
    (e) section 353 (location of register of members);
    (f) section 363 (duty of company to make annual returns); and
    (g) section 399 and 415 (company's duty to register charges which it creates).
(5) The extent of the director's responsibility for any failure by the directors of the company to comply with
    (a) section 226 or 227 (duty to prepare annual accounts), or;
    (b) section 233 (approval and signature of accounts.
(6) The extent of the director's responsibility for the causes of the company becoming insolvent
(7) The extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for (in whole or in part).
(8) The extent of the director's responsibility for the company entering into any transaction or giving any preference, being a transaction or preference –

This Schedule lists a very broad range of grounds upon which directors can be declared unfit for office and disqualified. Some of these grounds are: being in breach of duty to a company, mis-application of company assets, non-compliance with the Companies Act 1985, being in breach of duty to produce financial accounts, involvement in the insolvency of a company, non-compliance with the Insolvency Act 1986. Notwithstanding the long list of Schedule 1, the courts can take into account any other matter that is in the public interest.[169]

Though Schedule 1 provides a broad range of grounds for disqualification, it is simply the catalyst for wider interpretation of what is deemed unfit and the standards required to act in the management of a company. For Parker J, unfitness does not necessarily require automatic consideration of misfeasance or common-law duty of care; rather, a simple question of 'lacking in judgement' is sufficient.[170] Parker J's definition is rather limited because a director can be found unfit for the lack of other requisite qualifications. The phrase 'unfit for the management of a company' is an important part of s.6. The standard requires a consideration of the facts of a case more than it requires a prescription for what constitutes misconduct. The court is required to consider whether the facts of a case demonstrate that the individual is unfit to be concerned in the management of the company from all points of view, unless it gives the individual leave to act in the office of director in other companies.[171]

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(a) liable to be set aside under section 127 or section 238-240, of the Insolvency Act 1986; or
(b) challengeable under section 242 or 243 of the Insolvency Act 1986 (or any rule of law in Scotland).

(9) The extent of the director's responsibility for any failure by the directors of the company to comply with section 98 of the Insolvency Act 1986 (duty to call creditors meeting in creditors voluntary winding up).

(10) Any failure by the director to comply with any obligation imposed on him by, or under any of the following provisions of the Insolvency Act 1986 –
(a) section 22 (company's statement of affairs in administration);
(b) section 47 (statement of affairs to administrative receiver);
(c) section 66 (statement of affairs in Scottish receivership);
(d) section 99 (directors' duty to attend meeting; statement of affairs in creditors' voluntary winding up);
(e) section 131 (statement of affairs in winding p by the court);
(f) section 234 (duty of any one with company property to deliver it up);
(g) section 235 (duty to co-operate with liquidator, etc)

169 *Re Bath Glass Ltd* [1988] BCLC 329 at p. 332
170 *Re Barings (No. 5)* [1999] op. cit., n. 41, at 486
171 *Re Barings (No. 5)* [1999] op. cit., n. 41, at p. 482

It is suggested that ordinary commercial misjudgement or business folly is, in itself, not sufficient to justify disqualification.[172] Courts usually consider the position and responsibilities of the director in the company and his contribution to the loss or demise of the company. Unfitness would normally arise where there is a lack of 'commercial probity', or in an extreme case 'gross negligence or total incompetence' could be appropriate.[173] The standard highlights a number of circumstances where unfitness for the management of a company could be established, particularly where there is a lack of honesty, probity or even integrity in the way the company's affairs have been managed. It has been suggested that incompetence needs not be 'total' to render a director unfit. Incompetence arises in various degrees which could be deemed significant but not necessarily total. According to Dillon J in *Sevenoaks* the defendant's trouble was not dishonesty but 'incompetence or negligence in a very marked degree and that is enough to render him unfit'. [174] For example, incompetence need not be serious. In *Re Continental Assurance Co* 'serious incompetence' was interpreted as not following basic statutory provisions.[175] Moreover, a normal case will give rise to a number of persistent failures rather than one, such as filing annual accounts.[176] This is notwithstanding the fact that some isolated failures will be construed by the courts as serious enough to warrant disqualification. Consequently, according to Parker J, the conduct and the extenuating circumstances need to be viewed 'cumulatively'.[177] Therefore, when considering the question of director disqualification, the facts must give rise to a serious failure to manage the company and protect the public/shareholders interest.[178]

The purpose to s.6 is much broader than simply a question of unfitness. Within this the primary purpose is deemed not only to punish an individual but also to protect society from the past misdeeds of directors who have managed insolvent companies to the detriment of creditors and other interested parties. Consequently, to protect society it is inevitable that an individual's freedom should be restricted. The courts have not taken this role lightly and have justified their position by highlighting the intention of

[172] This is notwithstanding the fact in the US the law does have a "general business misjudgement rule", which does not exist in the UK
[173] *Re Lo-Line Electric Motors Ltd* (1988) op. cit., n. 160, at p. 419
[174] *Sevenoaks Stationers (Retail) Ltd* [1990] 3 WLR 1165 at p. 1178
[175] *Re Continental Assurance Co of London Plc, Secretary of State for Trade and Industry v Burrows and others* [1997] 1 BCLC 48 at p. 58
[176] See *Secretary of State v Ettinger* [1993] BCLC 896 at p. 899-900
[177] *Re Barings (No. 5)* [1999] op. cit., n. 41, at p. 484
[178] *Re Bath Glass Ltd* [1988] BCLC 329 op. cit., n. 169, at p. 333

Parliament to 'improve managerial safeguards and the standards for the long term good of employees, creditors and investors'. This intention has resulted in the 'need for higher standards', thus developing a regulatory regime which has never been more stringent.[179] His Lordship's view describes the broader purpose of a s.6 disqualification-orders as an intention to improve the corporate governance of companies. This view promotes the need for directors to perform their management responsibilities for the long-term good of stakeholders in a company. This is done by setting a climate resistant to director's relinquishing their duties to the office they hold. The decision to make directors unfit is to send a message to others regarding the public expectation linked to their office and the importance of maintaining high standards.[180] These are the underlying reasons for making orders under s.6 mandatory for at least two-to-fifteen years, to ensure that everyone whose conduct falls below the appropriate standard is disqualified for at least two years.[181]

It would be reasonable to assert that the minimum period of disqualification should be applied to those whose failures were not serious (the degree of culpability is low), and the maximum to those whose failures were serious failures (the degree of culpability is high). This rather arbitrary distinction would not really assist a court in dealing with this question and would lead to inconsistencies. However, a degree of clarity has been given by Dillon LJ. His Lordship endorsed the following categorisation of the disqualification period:

(1) "The top bracket of disqualification for the over ten years should be reserved for particularly serious cases where a director who has already had one period of disqualification imposed on him falls to be disqualified yet again
(2) The minimum bracket of two to five years' disqualification should be applied where, though disqualification is mandatory, the case is relatively, not very serious.
(3) The middle bracket of disqualification from six to ten years should apply for serious cases which do not merit the top bracket."[182]

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179 *Secretary of State for Trade and Industry v Gray and another* [1995] 1 BCLC 276 at p. 288-289
180 For a critique see, V Finch, 'Disqualification of Directors: A Plea of Competence', Vol. 53, May, *Modern Law Review* (1990), 385-391.K T Ong, 'Disqualification of directors: a faulty regime?', Vol. 19, No.1, *The Company Lawyer*, 7-10
181 *Gray and another* [1995] op. cit., n. 179, at p. 288
182 *Re Sevenoaks (Retail) Ltd* [1990] op. cit., n. 174, at p. 1169

Dillon LJ's categorisation adds very little to the above distinction, because it provides little assistance in determining the factors attributable to each division. Judicial precedent offer assistance in deciding which particular set of facts best characterise a particular bracket. Judges do, however, take into account the degree of seriousness, incompetence, dishonesty, and culpability when considering the period of disqualification. These criteria can be justified only by referring to the circumstances of each case. In the case of the directors at Barings, the disqualification period given was within the minimum bracket, thus suggesting that although the disqualification was mandatory the cases were not relatively serious. This suggests that Ms Mary Walz was less culpable in the demise of Barings Bank than the other directors. She was disqualified for two years only, whereas the other directors were given a minimum four and five years disqualification, which suggests that while their acts or omissions did not warrant a disqualification within the middle bracket. They were serious enough to warrant the highest period of disqualification within the minimum bracket. This could be based on the fact the other named directors played a greater role in the bank, and hence their lenient disqualification periods. The term 'serious' cannot be precisely defined in the absence of the context of a case.

#### 4.8.1.2 Charges Against The Directors of Barings-Conformity with the existing Standard of Care

The issues in the Barings debacle centre on charges against Tuckey, Baker and Gamby, regarding their responsibility for Leeson's trading. The first serious charge against them was that they were ineffective in their investigation of the circumstances surrounding the SLK receivable. This charge was brought against both Tuckey and Baker and was deemed serious in that the latter was held to have 'frustrated the investigation' and the former amounted to a 'high degree of incompetence'. In Gamby's case, Parker J's opinion was that his omission was equally culpable. The circumstances surrounding the SLK receivable may not alone have led to a decision of unfitness in the case of Tuckey. Other issues that came to light led to it, particularly the failure to examine the profitability of BFS. Both Tuckey and Baker had responsibility to examine the validity of the revenue from Leeson's activities. This was the responsibility of Tuckey because of his role as chairman of BIB and chair of MANCO. In the case of Baker the charge was brought because he was the head of the Financial Products Group and was required to ensure that Leeson was carrying on his business properly. An associated charge was brought against Gamby relating to the funding of Leeson's operations and compliance with s.221 of the Companies Act 1985. Gamby's evidence showed that he did not act upon the information before him, and this was deemed 'culpable to the extreme' failing to ensure compliance with the provision. The central failure at Barings was the lack of segregation of Leeson's activities. Both Tuckey and Baker were charged with this failure. It was Tuckey's responsibility to have been aware of this problem and for Baker to have rectified it. According to Parker J this was an 'absolute failure' on his part. Another key charge against Tuckey and Baker was that they did not properly monitor and/or control his activities in the widest sense. In the case of Tuckey it was argued that he failed to recognise his responsibilities or understand what Leeson was doing in terms of the switching business. This failure was deemed 'woeful' and a complete abdication of responsibility.

Barings (No. 3) highlights that in some cases the public interest will outweigh the interests of the regulated and the regulator and require punishment of those who have undermined the public expectations of a director.[183] What Barings, did not decide was whether a judicial disqualification was essential after a regulatory body effects the disqualification of a director. This issue is separate from the issue of allowing a disqualified to seek judicial redress. In other words, does the court have the authority to pronounce upon a decision taken by a regulatory body when that regulatory body is not in breach of the laws of natural justice in disqualifying a director?

Andrew Tuckey had not sought to registration with the SFA as a director;[184] Peter Norris was removed from the SFA's Register of Directors and required to pay £10,000 towards SFA's costs;[185] Geoffrey Broadhurst was removed from the SFA Register of Directors and Managers for three years and required to pay £10,000 towards SFA costs;[186] George Angus was suspended for two years; Anthony Hawkes was removed from the SFA's Register of Directors and Managers for three years; Anthony Gamby was suspended for one year as a director. All three were required to

183 A Walters, 'Directors' duties: the impact of the Company Directors Disqualification Act 1986', Vol. 21, No. 4, *The Company Lawyer*, (2000), 110-118
184 SFA, 'Barings individuals: SFA commences disciplinary action', Press Release 15th March 1996
185 SFA, 'SFA settles disciplinary proceedings against Peter Norris', Press Release 7th March 1996
186 SFA, 'SFA concludes action against ex-Barings director, Geoffrey Broadhurst, Press Release 28th May 1996

pay towards SFA's costs.[187] Mary Walz was reprimanded and required to pay £5,000 towards SFA costs[188]; James Bax was suspended from the SFA's Register of Directors and required to pay £5,000 towards SFA's costs;[189] Ian Hopkins was removed from the SFA's Register of Directors and Managers for three years and ordered to pay £10,000 towards the SFA's costs.[190] Barings did confirm that directors are certainly accountable to shareholders/stakeholders, a move apparently made in the interest of maintaining public confidence.

The decision by Parker J in *Barings (No. 5)* established a modern-day proposition about the scope of directors' duties without totally breaking away from the traditions set by previous cases such as *Re Equitable Insurance*. Barings brings the central cases in company-law into the modern era by reasserting their salient features and by underlining the objective and subjective tests enshrined in s. 214(4) of the Insolvency Act 1986, which sets out the criteria of care, skill and diligence required by directors. The three general propositions that underpin directors' duties are:

(i) "directors had, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.

(ii) Whilst directors were entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation did not absolve a director from the duty to supervise the discharge of the delegated functions.

(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it had been discharged, depended on the facts of each particular case, including the director's role in the management of the company."

The modern-day proposition is distinct because of the context of Parker J's decision, which is underpinned by the policy considerations of the CDDA 1986 rather

187 SFA, 'Ex-Barings Directors Disciplined', Press Release, 27th August 1996

188 SFA, 'SFA concludes disciplinary proceedings brought against Mary Walz', Press Release, 10th January 1997

189 SFA, 'SFA disciplines ex-Barings Director James Bax', Press Release 25th February 1997

190 SFA, 'Mr Ian Hopkins', Press Release 11th March 1997

than by the general rules of duty of care. The essential policy-considerations of the CDDA 1986 are deemed to be the protection of the public from unfit directors who are judged to be incompetent, dishonest or are generally culpable for the mismanagement of a company's affairs. The CDDA 1986 provides a deterrence-based approach to the area of directors' duties and responsibilities by imposing disqualification orders on delinquent directors and thus preventing them from undertaking such office for a particular period of time. The CDDA 1986 does not provide life bans; such a draconian measure would, in many respects, deter individuals from the position of director and undermine the all-important 'entrepreneurial spirit' of a company. Rather, the CDDA 1986 provides a specific period of disqualification (2-15 years). The length of the periods of disqualification is proportionate with the level of culpability. Another facet to this deterrence-based approach is the publicity which it attracts, and the entry on the central register of disqualified directors.[191] This public naming and shaming adds to the overall punitive effect of a disqualification order. Moreover, it provides visibility of public expectations and a basis for accountability for those initiating the disqualification proceedings.[192] For example, the public is actively encouraged to 'blow the whistle' on directors who are suspected of breaching their terms of disqualification.[193]

### 4.9 Conclusion

'Banking' consists of a number of financial businesses which have brought to the fore the limits of traditional forms of banking regulation and supervision. The growing complexity of banks where transactions are executed in seconds makes regulatory oversight of their global trading business very difficult. The uniqueness of banks has not led to over-regulation and restrictions upon the businesses they can participate in. Rather, capital-adequacy has evolved to safeguard against the risks a bank is exposed to. Notwithstanding these developments in capital adequacy, corporate governance has an obvious importance in ensuring the safety of depositors and to assuage concerns about stability.

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[191] This is given further assistance by Companies House who list disqualified directors on their web-site

[192] For further analysis of enforcement sanctions see: Chapter 5 Enforcement Method and Sanctions in Banking Regulation and Supervision

[193] D Milman, 'The effectiveness of the disqualification regime: a progress report from the National Audit Office', Issue 4, *Mithani News Letters*, (1999)

This could lead to two general solutions: a response of over-regulation or the recognition of greater corporate responsibility and oversight. In some ways the latter reduces the theoretical `expectations gap' prevalent in regulation by holding management and boards of directors responsible for losses and failures that may ensue from their business judgement. Regulation can provide only limited safeguards, such that the ultimate responsibility for protecting the interests of depositors and the shareholders remains with the authorised institution itself. Furthermore, the loss or collapse of an authorised institution does not always lead to an overhaul of the regulatory order, but rather, results in an investigation and enhancement of the operational aspects of regulation and supervision.[194] A radical overhaul, or indeed, a single regulatory strategy, could not effectively keep pace with entities that are continuously evolving. This is why an effective and accountable, discretion-based approach is deemed appropriate, one that relies on 'experienced judgement' to apply to fluctuating conditions what may seem to be narrow or ambiguous rules.

It is clear from the evidence of recent failures among the regulated industries that effective corporate governance is crucial to ensure the safety of depositors, and that capital-adequacy on its own could provide only limited cushion against failure. In order to understand the relationship between regulator, auditor and banker one must have a view of corporate governance broad enough to transcend the simple idea that the management- function ~~s~~ does nothing more than increase shareholder wealth. Regulation has not attempted to diminish this relationship, but rather, complement it with an umbrella of regulations to safeguard third party interests. Regulators have attempted to ensure that regulation has not stifled the entrepreneurial spirit of essentially profit-making institutions. Basel has rightly adopted a broad interpretation of the OECD definition of corporate governance to include a wider range of stakeholders such as depositors, regulators and governments. It is important that regulators ensure that the interests of these parties are included in the decisions made by authorised institutions to make sure that shareholder interests do not simply override other stakeholder concerns.

A number of tools for effective corporate governance exist. However, regulators have attempted to emulate commercial practice rather than build on them to complement the regulatory regime. Review of the various mechanisms does strongly

[194] This is clear from Chapter 7 Accountability of Regulatory Decisions at p. 248

suggest that more can be achieved through the audit committee and internal audit. It is crucial that these facets of internal governance are effective at ensuring ensure that directors' and management's decision-making is transparent and accountable. Independence in the using of effective internal-audit tools is a pre-condition of adequate corporate governance. Such tools are forged by management to serve management and shareholder interests, and are therefore prone to 'capture'. A code of regulatory responsibility should be included in the constitutions of audit committees to build upon the common-law duties of non-executive directors in exercising skill, care and diligence. This would provide an appropriate platform for discussing the financial affairs of an institution with the regulator, independently of that institution.

Integral to the whole area of corporate governance is the importance of effective directorships and senior management. Directors' duties within banking regulation have evolved in line with the common-law tradition of skill, care and diligence with the responsibility to act in accordance with regulatory obligations. The duty of care concept has moved away from the idea of non-specialist risk-taker, where the entrepreneurial spirit was paramount and not stifled. The introduction of competency rules for directors will provide a strong platform to judge whether they are fit and proper. However, it is unfortunate that the new regulatory order does not prohibit multiple directorships.

The test for 'due diligence' conducted with objective and subjective criteria, has been given weight by the CDDA 1986 and the decision in *Re Barings (No. 5)*, which placed the 'due diligence' test firmly into the category of deterrent/punitive sanction. These developments have influenced the design of the FSA's rules governing approved persons and those with senior management responsibilities and will surely determine the way future acts or omissions of such individuals will be judged. It is also interesting to note that the introduction of the notion of reasonableness will mean a greater change for those regulated under the SIB regime and therefore governed by an 'effects-based approach'. Rather than for banks authorised under the 1987 Act, for whom standard of reasonableness outlined by s.16 Statement of Principles. The FSA's new approach highlights that it is moving away from the idea of absolute test (thus also away from absolute liability) towards reasonableness.[195]

[195] FSA, Consultation Paper 20 Feedback Statement, Oct (1999) at p. 13, para., 32

# Chapter 5

# Enforcement Methods and Sanctions in Banking Regulation and Supervision

## 5.1 Introduction

The prominence of the City of London in terms of international finance and the importance of this business to the whole economy places the enforcement policy of the Financial Services Authority (FSA) under the spotlight because enforcement strategies are crucial in maintaining confidence and depositor protection in the financial markets and for reducing fraud and other malpractice. The methods of enforcement by a regulator to maintain confidence include both compliance- and deterrence-based strategies. However, it is generally the case that compliance strategies underpinned by persuasion and negotiation are the normal mechanisms to ensure co-operation. The compliance-based approach is legitimated by the fact that the majority of regulated institutions do co-operate and accept supervision as a mechanism of social control. To determine the right enforcement action in any given situation, it is important to assess whether the regulated are a cohesive whole or a collection of disparate groups for which a range of enforcement methods is necessary in the pursuit of optimum compliance.

The regulator has a wide discretionary mandate which manifests itself on a day-to-day basis as negotiation and persuasion to ensure compliance.[1] This discretionary mandate also requires the regulator to serve many interests, *i.e.* to represent both the general public and the regulated. In such circumstances, the regulator is required to assess how best to serve the various interests without placing the claims of one group above that of another. The bargaining power of the regulated is prominent in how rules are devised and applied.[2] These issues raise the concern that regulatory decisions could, as Bardach and Kagan suggest, be perceived as 'over

[1] N Reichman, 'Moving Backstage: Uncovering the Role of Compliance Practices in Shaping Regulatory Policy', at p. 328, in R Baldwin *et al.*, *Reader in Regulation*, Oxford, Oxford University Press (1998); and J Black, 'Talking about Regulation', Spring, *Public law*, (1998), 77-105 at p. 91

[2] K Hawkins and J M Thomas, 'The Enforcement Process in Regulatory Bureaucracies', in K Hawkins & J Thomas, *Enforcing Regulation*, Boston, Kluwer Nijhoff (1984) at p. 15

stringent' and/or 'over accommodative'.[3] An over-stringent enforcement strategy could undermine a regulatory regime by excessively increasing the cost of regulation and compliance; an over-accommodative regime could give the impression of lax regulation and allow a high degree of capture. These concerns can be avoided with appropriate levels of accountability to ensure proportionality, fairness and consistency.

The issue of enforcement strategies is considered in this Chapter on banking supervision, with reference to the style of enforcement by the Bank and the FSA, pursuant of the Banking Act 1987[4] and the FSMA 2000, and by drawing on the relevant socio-legal literature. In order to examine whether banks are special and warrant a specific enforcement strategy to safeguard the interests of depositors, there is a comparison of the UK approach with that of the US Federal Reserve. In addition to the examination, it is important to consider whether the metaphor 'Benign Big Guns'[5] is an appropriate reference to central bankers, or one that can be detrimental to the reputation of the regulatory agency because of its perceived lack of public enforcement. Sections 1-4 of this Chapter reviews and analyses the literature on enforcement, with focus on the necessity of both compliance- and deterrent-based approaches. Secondly, an analysis of punitive sanctions is undertaken. It is suggested that middle-ground sanctions are necessary to deter non-compliance. Sections 6-1 provides a review and analysis of the style of enforcement adopted by the Bank and the FSA. It is suggested that there need to be a pragmatic approach to enforcement decisions about those authorised in the deposit-taking business. Finally, there is a review of the sanctions prescribed by the requisite legislation, and it is suggested that the use of publicity and fines provides the necessary middle-ground sanction that shows enforcement in banking supervision to be taking place.

### 5.2 Legitimacy of the Compliance-Based Approach

Ensuring observance of rules requires two forms of enforcement method: the compliance (pre-monitory) and the deterrence (post-monitory). The two enforcement

[3] Ibid., K Hawkins *et al*, (1984) at p. 7

[4] Financial Services Authority, Statement of Principles: Issued in Accordance with the Banking Act 1987 and the Banking Coordination (Second Council Directive) Regulations 1992, London, FSA (1998)

methods can be seen as the opposite poles on a compliance-continuum.[6] Both are parts of the mechanism 'control'.[7] However, modern society has tended to encourage a compliance-based approach to regulatory enforcement because trust systems are the basics of co-operation when the aim of regulatory enforcement is to reduce the likelihood of a 'breach of trust'.[8] In a complex society, the two approaches are essential and inter-dependent in ensuring compliance with the regulatory regime and in bringing sanctions against activities that adversely affect the economy. The bargaining power of the regulated provides them with strong leverage to negotiate on what constitutes legitimate regulation their most drastic ploy being the threat to move business to locations where compliance costs are cheaper.

The literal meaning of 'compliance' is 'conformity'. The legitimacy of the compliance-based approach has been considered from various perspectives in a number of empirical studies.[9] A compliance strategy is an approach based on co-operation rather than punishment,[10] and requires institutions to comply with the orders of a higher authority, such as a regulator, who can compel or influence change.[11] This shows that compliance is not simply a method of enforcement underpinned by co-operation and mutual trust, and that it has much greater influence in a regulatory order.

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[5] I Ayres & J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford, Oxford University Press (1992) at p. 40

[6] N Gunningham, 'Negotiated Non Compliance: A Case Study of Regulatory Failure', Vol. 9, No. 1, January, *Law & Policy*, (1987) 69-95 at p. 70

[7] R Cotterell, *The Sociology of Law: An Introduction*, London, Butterworths (1992) at p. 245

[8] A J Reiss, Jr, 'Selecting Strategies of Social Control over Organizational Life', K Hawkins, *et al* (1984), op.cit., n. 2, at p. 32

[9] See generally: J T Scholz, 'Cooperation, Deterrence, and The Ecology of Regulatory Enforcement', Vol.18, No. 2, *Law & Society Review*, (1984) 179-224; R Brown, 'Theory and Practice of Regulatory Enforcement: Occupational Health and Safety Regulation in British Columbia', Vol.16, No.1, *Law & Policy*, January (1994) 63-91; T Makki & J Braithwaite, 'Praise, Pride and Corporate Compliance', 21, *International Journal of the Sociology of Law*, (1993) 73-91; B M Hutter, 'Variations in Regulatory Enforcement Styles', Vol. 11, No. 2, *Law & Policy*, April (1989), 153-174; P J May & R J Burby, 'Making Sense Out of Regulatory Enforcement', Vol. 20, No. 2, *Law & Policy*, April, (1998), 157-182; B M Hutter, *The Reasonable Arm of the Law? The Law Enforcement Procedures of Environmental Health Officers*, Oxford, Clarendon Press (1988); D Cook, *Rich Law, Poor Law: Differential Response to Tax and Supplementary Benefit Fraud*, Milton Keynes Open University Press (1989) at p. 104; and A Hopkins, 'Compliance with what? The Fundamental Regulatory Question', Vol. 34, No. 4, *British Journal of Criminology*, Autumn, (1994), 431-443

[10] K Hawkins, *Environment and Enforcement: Regulation and the Social Definition of Enforcement*, Oxford, Oxford University Press (1984) at p. 4

[11] D Thompson (ed), *The Oxford Compact English Dictionary*, Oxford, Oxford University Press (1996) at p. 461

Deterrence should be considered a factor in ensuring compliance by negative means, which is the other side of compliance. The deterrence-based approach is traditionally seen to be centred on retribution and last resort in a process of ensuring observance in a regulatory regime. According to Bardach and Kagan, a purely punitive policy can produce a degree of 'resistance', and a purely persuasive approach does not recognise there are some who are not going to co-operate.[12] From the various studies of regulatory enforcement, it is clear that variation prevails in both compliance and deterrence. The way violations are dealt with highlights their distinguishing features. In the case of compliance, the imposition of a penalty is a sign of its failure, whereas, in a deterrence-based approach it is deemed a sign of success. [13]

The deterrence approach focuses on 'immediately harmful' behaviour, which is then penalised, whereas the compliance approach focuses on technical violations that are discouraged with inducements.[14] Other factors that may be taken into account are the cost and complexity of the violations. Compliance is considered the most efficacious strategy because it ultimately aims to ensure observance through the minimum of resources. This is supported by the studies undertaken by Ayres and Braithwaite, who argue that persuasion is considered less expensive than prosecution. Moreover, a punitive approach creates a regulatory environment of 'cat and mouse'.[15] It is suggested that in certain cases, when public interest warrants it and for the preservation of regulator 'credibility', prosecution is the only rational recourse in incidents of gross non-compliance, such as persistent non-compliance that causes substantial 'damage'.[16]

### 5.2.1 Education and Incentives

The concept 'compliance' has sub-components: Consultation and education are important ones, for they enhance communication and provide the regulated with

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[12] Bardach and Kagan cited in I Ayres and J Braithwaite (1992), op. cit., n. 5, at p. 25 "To reject punitive regulation is naive; to be totally committed to it is to lead a charge of the Light Brigade. The trick of successful regulation is to establish a synergy between punishment and persuasion."

[13] Reiss, in K Hawkins, *et al* (1984), op. cit., n. 2, at p. 25

[14] Reiss, in K Hawkins, *et al* (1984), "[i]n deterrence systems, penalties serve notice that all violators will suffer a similar fate; in compliance-based systems, they serve notice that the law enforcement system has been unable to secure compliance. " op. cit., n. 2, at p. 24

[15] I Ayres and J Braithwaite (1992) op. cit., n. 5, at p. 26

[16] K Hawkins, 'Law as Last Resort', in R Baldwin et al (eds), *Reader on Regulation*, Oxford, Oxford University Press (1998) at p. 298

an environment in which they are not threatened if problems do occur.[17] It is said that this type of approach fosters greater mutual respect of roles rather than division and hostility. Indeed, it is important in complex regulatory environments to see education as a two-way process, especially when the regulatory environment is constantly changing. In such circumstances, regulators depend on the regulated to provide them with the knowledge of how to best regulate such activities. This process is especially utilised when rules are being negotiated and forums and committees are set up to gather and disseminate best-practice advice. Though such activities could raise concern about regulatory capture because of the bargaining power wielded by the regulated, the process does provides an environment of mutual trust, and this can outweigh such concerns.

Another position on the compliance continuum is occupied by incentives from regulatory bodies.[18] Grabosky is cautious in his encouragement of the use of incentives, even though they could reduce the burden of regulation. Incentives generally provide positive inducements for co-operation with the regulator, which negative penalties such as disqualification or market disclosure do not.[19] For example, incentives vary from grants and subsidies, favourable administrative considerations, praise or, in the case of the banking supervision, regulatory holidays. Regulatory holidays are periods when an authorised institution is relieved of the burden of inspection because of its good track record in compliance with regulatory requirements. A further aspect of incentive schemes is to 'come clean' with problems. This provides the regulated with the possibility of a lesser sanction or, in some cases, no punishment at all.

Advocates of compliance focus on how efficiently regulatory resources are utilised.[20] According to Scholz, society benefits from adopting a compliance style of enforcement because it minimises enforcement costs and reduces the cost of

[17] K Hawkins, *et al* (1984) op. cit., n. 2, at p. 82
[18] P N Grabosky, 'Regulation by Reward: On the Use of Incentives as Regulatory Instruments', Vol. 17, No. 3, July, *Law & Policy*, (1995) 257-282
[19] *Cf.* C Hawkesby, "New Zealand's Approach to Banking Supervision: An Emphasis on Market Incentives and Accountability", Conference on "Rules, Incentives and Sanctions: Enforcement in Financial Regulation", Financial Markets Group, London School of Economics, 26th May (2000)
[20] P N Grabosky, (1995) op.cit., n. 18 at p. 259

compliance[21]. Concern about costs suggests that the co-operative approach is thus a compromise. It is the case that broad mandates that advocate the importance of cost and efficiency do not necessarily provide guidelines for measuring the efficiency of a particular regulatory approach. Therefore, focus on efficiency and cost in such circumstances may not note the social consequences of a compliance approach in its attempts to rectify problems in the confines of the regulatory relationship. In some circumstances, negotiated compliance may not be the appropriate method of ensuring observance. The optimal enforcement style is essentially a combination of compliance/deterrence styles, as distinct from the single-strategy approach, which is not capable of ensuring compliance by a majority in the regulated industry. The decision governing which enforcement style to adopt in any particular case is difficult to determine. Having at hand a broad enforcement style would allow the regulator to choose the most appropriate course of action.

### 5.3 The Regulated and Choice of Regulatory Enforcement Strategy

Whether a deterrence or an enforcement style of securing compliance applied depends on the perception the regulator has of the regulated. It is important to recognise that it would be a huge misconception to consider the regulatory environment as a single, cohesive body. It is more appropriate to view it as a plurality of participants with various interests and objectives.[22] Attempt to categorise them would be crude and the outcome simplistic. Hence the need for the regulator to exercise judgement on a case-by-case basis, on facts before him, and to select the suitable enforcement strategy in their light.

According to Kagan and Sholtz, the regulated can be categorised as three roughly distinguishable types, and the regulator can use their typology as a guide in deciding upon the most appropriate strategy for ensuring optimal compliance. The first 'type' is the 'amoral calculator' who is motivated purely by profit and has taken into account the probability of being caught. The second, the 'political citizen', is inclined for a number of reasons to comply with the law. His non-compliance stems

[21] According to J T Scholz, 'Voluntary Compliance and Regulatory Enforcement', *Law and Policy* October, (1984) 385-404 "[A] co-operative solution to the enforcement dilemma is advantageous for society as a whole." at p. 392
[22] R A Kagan & J T Scholtz, 'The Criminology of the Corporation and Regulatory Enforcement Strategies' in K Hawkins et al, (1984) op. cit., n. 2, at p. 67

from orders he perceives to be arbitrary or unreasonable. The third is the 'organisationally incompetent', his non-compliance stemming from organisational failure. These images highlight the mixture of institutions which make up the regulatory environment. According to Kagan and Scholtz, a different approach to enforcement is required for each.

In the case of the 'amoral calculator' a deterrence strategy that consists of an aggressive inspection regime and a prompt imposition of penalties is required. The 'political citizen' requires an altogether different, persuasive approach that attempts to adjust or even suspend regulation to ensure legitimate business is not undermined. In the case of the third type the 'organisationally incompetent', the regulator should act as a consultant and educator. Kagan and Scholtz put forward enforcement strategies , that 'capture an important aspect of reality'. An enforcement strategy that does not focus on a regulatory environment that consists of a mixture of 'amoral calculators', 'political citizens' and 'organisational incompetents' will ultimately be counter-productive.

The idea that the regulatory environment does not consist of a single, cohesive group is advanced also by Ayres and Braithwaite, who suggest that among the regulated there is a diversity of factors that motivate compliance. They see firms in an industry as economic actors motivated by a number of things, both rationally and irrationally. It is for the regulator to recognise both motivations and to ensure that there are appropriate sanctions against the non-compliance of both the rationally and irrationally motivated.[23]

### 5.4 Administrative Discretion and Transparency

A broad enforcement policy that does not rely solely on any one particular form of enforcement strategy provides the appropriate foundation for regulation.[24] Ayres and Braithwaite attempt to build on the game-theorists' approach (the 'tit-for-tat' strategy) to regulatory enforcement. This is said to work well in constraining non-compliance and at promoting trust and civic virtue. In this approach, the initial

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[23] I Ayres and J Braithwaite (1992) op. cit., n. 5, at p. 30

[24] B M Hutter, 'An Inspector Calls: The Importance of Proactive enforcement in the regulatory context', Vol. 26, No. 2, *British Journal of Criminology*, April, (1996), 114-128 at p. 117

response to ensuring observance of the regulatory order is to co-operate, but this is not done on the assumption that all institutions will. According to Bardach and Kagan, a formalised, legalistic enforcement policy could not incorporate 'the sheer diversity of the causes of harm that arise in a large technologically dynamic economy'. So it can be reasonably asserted that discretion in enforcement-action is necessary, provided safety mechanisms are in place in order to ensure that decisions are consistent and appropriately accountable. Whilst this does not mean strictly advocating a rules-based approach, it does recognise the importance of reducing arbitrary decision-making.[25] According to Hutter, this is based on the idea of compromise between 'legalism' and 'uncontrolled discretion', because a wide discretionary approach raises the ultimate concern of arbitrary decision-making in enforcement matters and the importance of enforcement agents' balancing of potentially conflicting objectives.[26] For Danaceau, it is possible for inspectors to respond to the concerns of the industry without compromising the objectives of the regulatory order.[27] However, this could be consistently ensured only if safety measures are independently verified, possibly by setting up an independent enforcement committee. It is generally assumed that the regulator is an 'expert body' and will thus use its expertise to resolve disputes in accordance with its delegated discretionary responsibilities.[28]

'Regulatory capture' is where the regulator serves the regulated rather than the public, requires addressing. However, it would be a misconception to think that regulators are not aware of capture. Notwithstanding this fact, the discretion-based approach where judgement is unstructured does raise concern for more consistency. This is particularly so when the statistics about regulatory offences show an inconsistency of approach to offenders who are small institutions and to large,

[25] K C Davis, *Discretionary Justice: A Preliminary Inquiry*, Urbana, University of Illinois Press (1971) at p. 27; J Jowell, 'The Legal Control of Administrative Discretion', *Public Law* (1973) 178-220 at p. 179; R Baldwin & K Hawkins, 'Discretionary Justice: Davis Reconsidered', *Public Law* (1984) 570-599 at p. 580

[26] B M Hutter, (1996) op. cit., n. 24, at p. 117

[27] P Danaceau, 'Developing Successful Enforcement Programs', in E Bardash & R A Kagan (eds), *Social Regulation: Strategies for Reform*, San Francisco, Institute for Contemporary Studies (1982) at p. 143

[28] R A Kagan, 'Regulatory Inspectorate and Police', "When they encounter probable violations, police and inspectors alike make discretionary judgements. They must make on-the-spot assessments of the adequacy of their evidence ("Will an arrest... or regulatory citation ... hold up in court?"), in K Hawkins, *et al*, (1984), op. cit., n. 2, at p. 41

powerful ones.[29] Clear public interests-warrant some form of structure to ensure the independence of decision-making in order for it to have credibility.[30] Regulatory capture occurs also where a regulatory authority has the additional role of promoting and safety and conflicts of interests arise. For example, in Carson's study of health and safety issues relating to North Sea Oil Rigs, the fact that the Health and Safety Inspectorate was not given the responsibility of monitoring safety led to a number of problems which were not addressed by the Department of Energy because a trade-off between safety and cost meant efficiency prevailed. Carson's conclusions were that economic interests from exploration at that time out-weighed the interests of the workers on the rigs, thus creating a conflict of interest.[31]

### 5.5 The Exercise of Civil and Criminal Sanctions

It is clear that the regulator needs a number of regulatory-enforcement sanctions at its disposal to underpin the broader picture of deterrence. Moreover, the choice of 'sanction' is dependent upon the choice of where on the deterrence continuum regulatory action is to take place. It is important to analyse the different types of sanction in order to see how regulatory offences are punished and to examine the growing use of punitive civil sanctions which, in the author's opinion, equate with criminal sanctions in terms of impact, punishment and retributive effect. The consequence is that only a small percentage of enforcement-decisions are shown in banking supervision. The regulator's administrative discretion in the selection of sanctions, and the policy-reasons for the growing utilisation of administrative and civil sanctions to ensure conformity with the regulatory order, will be considered.

While the Bank could be deemed a *prima facie* Benign Big Gun, an important omission is the fact that it does not have an appropriate range of sanctions, other than the 'nuclear option', such as publicity, fines and formal warnings as a prelude to punitive sanctions. In Ayres and Braithwaite's pyramid of enforcement the base consists of 'persuasion' followed by a 'warning letter', 'civil penalty', 'criminal

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[29] D Nelken, 'White-Collar Crime', in D Nelken, (ed) *The International Library of Criminology, Criminal Justice and Penology: White - Collar Crime*, Aldershot, Dartmouth Publishing (1994) at p. 377

[30] N Gunningham & P Grabosky, *Smart Regulation: Designing Environmental Policy*, Oxford, Clarendon Press (1998) at p. 44; and R Posner, Theories of Economic Regulation' Vol. 5 *Bell Journal of Economics*, (1974) 335-380

[31] W G Carson, *The Other Price of Britain's Oil*, Oxford, Martin Robertson (1981) at p. 145

penalty', 'license suspension' and finally, at the apex of the pyramid, 'license revocation'.[32] In this pyramid 'middle-ground sanctions' are encouraged.

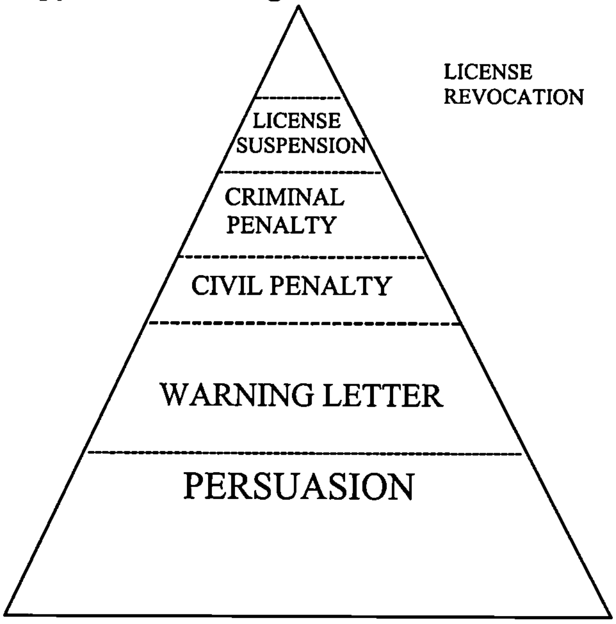


*Figure 1*: Ayres and Braithwaite enforcement pyramid

One may like to consider whether publicity of such enforcement-decisions would add to the list of sanctions available, bearing in mind, of course, the ethos of London financial markets' operation. This is something the Federal Reserve in the US has utilised effectively in ensuring market discipline and recognition that enforcement is taken seriously.

### 5.5.1 The Decriminalisation of Regulatory Offences

The purpose of sanctions can either be to punish and/or to compel change, and for the purpose of deterrence and/or coercion, to ensure that appropriate regulatory behaviour is achieved. The central idea behind criminal (penalties) and civil (remedies) sanctions has traditionally remained distinct. According to Lord Mansfield, '...there is no distinction better known than the distinction between civil and criminal law; or between criminal prosecutions and civil actions'.[33] The distinguishing features of criminal and civil sanctions are, on an abstract level, not as distinct as first thought. This is because of the growing use of punitive civil sanctions.[34] The essential attribute of criminal law that distinguishes it from civil sanctions is the *mens rea*. The mental element in *mens rea* can be assessed objectively

[32] I Ayres & J Braithwaite (1992) op. cit., n. 5, at p. 35
[33] *Atcheson v. Everitt*, 98 Eng. Rep. 1142, at p. 1147

or subjectively, and is based on the mental state of the individual alleged to have committed some form of social harm. This can result in imprisonment and/or a fine, the main forms of punishment administered. The stigma attached to incarceration or criminal fine is also a form of chastisement. Consequently, criminal law in any regulatory regime is reserved for the most severe regulatory offences where there is moral disapproval and a high degree of culpability.

In civil law, the remedy can impose stigma because the order by the court indicates failures to achieve a particular standard of behaviour. This is established on the objective assessment of an act or omission which results in some form of damage or loss due to the shortfalls in standard of care objectives. Civil law consists of a number of procedures for achieving equity and fairness between parties, such as injunctions or orders for restitution, which attempts to crudely place the parties in their original or desired positions. The growth of a compliance-based approach means that trust in a fiduciary relationship calls into question the honesty of the individual and raises the legitimate call for protection and compensation. When one considers the concept 'honesty', one moves beyond the objective standard of behaviour into the realms of the subjective element 'intent', thereby blurring the civil and criminal divide. In the regulatory context, a greater overlap between criminal and civil sanctions exists under the auspices of administrative powers.[35]

The popularity of civil sanctions has resulted from the process of decriminalising regulatory offences and led to the use of criminal law for only severe cases, which are *mala in se*.[36] The decriminalisation process advocated new forms of sanctions. These focus on contraventions, surcharges, transgressions and violations. The new offences move away from the connotations of criminal law and remove the sense of that which is publicly reprehensible. It will be asserted that an enforcement policy should not consist only of purely punitive sanctions, nor, on the other hand,

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[34] K Mann, 'Punitive civil sanctions: The middleground between criminal and civil law', Vol. 101, *Yale Law Journal*, (1992), 1795-1873

[35] For the use of criminal sanctions see, S H Kadish, 'Some Observations on the use of Criminal Sanctions in Enforcing Economic Regulations', Vol. 30, No. 3, *The University of Chicago Law Review*, Spring (1963), 423-449; 'Developments in the Law, Corporate Crime: Regulating Corporate Behaviour through Criminal Sanctions', Vol. 92, *Harvard Law Review*, (1979), 1227-1375

[36] L J Kerrigan, *et al*, 'Project: The Decriminalization of Administrative Law Penalties: Civil Remedies, Alternatives, Policy, and Constitutional Implications', Vol. 45, *Administrative Law Review*, Fall, (1993), 367-434

should it consist of sanctions which are essentially empty gestures to the regulatory environment. What is of concern are the emerging civil sanctions (revocation and restrictions) which can be somewhat more punitive and stigmatising than criminal sanctions, resulting in the regulatory agencies becoming 'top heavy' in terms of enforcement sanctions.

The importance of having non-punitive civil sanctions is crucial. The prevalence of civil administrative sanctions in regulatory agencies has arisen for a number of reasons, but the key reason is that they are deemed easier to prove in comparison with criminal offences, which consist of a number of legitimate safeguards to ensure that a person's liberty is not undermined. The power to execute particular sanctions in regulatory agencies (especially civil sanctions) makes it easier to administer them through the designated Tribunal rather than through court proceedings. This then avoids higher costs and increases the speed of reaching a decision. Moreover, the implementation of administrative civil sanctions means the revenue from such decisions is reaped by the regulatory agency. This can be legitimatised in two ways. Firstly, it reduces the burden in terms of budgetary cost on the wider regulatory community; secondly, non-monetary sanctions such as imprisonment (which should be left for those not deterred by civil sanctions), are socially more expensive.[37] The funds raised through civil sanctions can be more efficiently distributed to those who have suffered loss and require compensation. Notwithstanding these advantages, caution needs to be taken to avoid simply substituting civil sanctions for onerous criminal sanctions.[38]

Less punitive civil sanctions provide the middle-ground, thus reducing the likelihood of under-enforcement and over-enforcement. The issue of whether the purpose of regulatory sanctions is punitive or non-punitive requires consideration of whether the aim of the sanction is remedial or retributive. In terms of deterrence, the primary objective of regulatory sanctions is to reduce undesirable activities which could undermine the purpose of regulation. The ramification of the growth of civil punitive sanctions and criminal sanctions means, firstly, that they are allocated to a

[37] R A Posner, *Economic Analysis of Law*, Boston, Little, Brown (1986) at p. 209. S Shavell, 'Criminal Law and the Optimal Use of Non-monetary Sanctions as a Deterrent', Vol. 85, *Columbia Law Review*, (1985), 1232-1262

minority of cases and secondly, the low prosecution rates and revocation rates arise among regulatory agencies.[39] A crucial factor in the utilisation of criminal sanctions is the limited application of the sanction, especially when the culprit is a company rather than an individual.[40] Criminal law is then a residual sanction which should continue to reinforce social solidarity based on basic values. Routine sanctioning could be achieved through less punitive civil sanctions, which are capable of a broader reach because of their less serious implications and less burdensome procedural setting.[41] However, in the case of banking regulation and supervision, Mann's reasoning may be over-simplistic because of the inherent effect of both criminal sanctions and punitive civil sanctions such as revocation or restrictions. What may then be more appropriate is the utilisation of non-punitive sanctions, ones that address regulatory failures but have little or no systemic consequences. The attempt to increase the use of non-punitive civil sanctions could directly increase enforcement activity in the intermediate range of offences without the market closing its doors on a participant. The use of such sanctions could not only enhance the public profile of a regulatory agency and reduce the possibility of collapse, but also reduce the possibility of allegations of negligence or actions in bad faith (misfeasance in public office).[42] Intermediary sanctions are crucial in order to complete the enforcement spectrum of sanctions. They could, on occasion, reduce the stigmatisation linked to criminal prosecutions. Punitive civil sanctions could only limit the likelihood of stigmatisation in cases of economic offences. In the case of publicity, the shame can also act as a deterrent because of the link between the offender and the regulatory community.[43]

### 5.5.2 The Question of Burden of Proof

The way the courts deal with cases between the criminal/civil dichotomy reveals the concerns for safeguards to control the application of punitive civil sanctions. This is particularly the case when, in the regulatory sphere, individual

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[38] L Kerrigal, *et al*, (1993) op. cit., n. 36, at p. 433
[39] *cf with* K Mann, (1992) op.cit., n. 34 see: J C Coffee Jr, 'Paradigms Lost: The Blurring of the Criminal and Civil Law Models – And What Can Be Done', Vol. 101, *Yale Law Journal*, (1992) 1875-1893, at p. 1875
[40] G Slapper and S Tombs, *Corporate Crime*, London, Longman (1999) at p.
[41] K Mann, (1992), op. cit., n. 34, at p. 1863; and see: Susan Shapiro, 'The Road Not Taken: The Elusive Path to Criminal Prosecution for White-Collar Offenders', Vol.19, No. 2, *Law & Society Review*, (1985), 179-221 at p. 193
[42] *Three Rivers DC v Governor and Company of the Bank of England* HL [2001] 2 All ER 513

liberty, integrity and livelihoods are at stake, irrespective of whether one is considering criminal or civil disciplinary actions and is notwithstanding the fact that evidentiary burdens between criminal law and civil law are traditionally distinct. The key distinguishing feature of the burden of proof in criminal law is 'beyond reasonable doubt', whereas in civil law it is based 'on a balance of probabilities'. This distinction exists because criminal law provides a number of sanctioning qualities not traditionally seen in civil law. The standard of proof provides a safeguard to ensure that an individual's liberty and the stigma associated with criminal sanctions is not threatened without proof 'beyond reasonable doubt'. The courts may, in civil offences, require the respondent to establish intent or dishonesty but, in many civil regulatory offences, such standards of proof are not always applied in practice, even though they are required. This raises the concern that a regulatory tribunal could be deciding a case on a standard that is less than a court would demand to ensure a fair trial.

Can civil sanctions be equated to criminal sanctions? In all civil actions the traditional burden of proof is a balance of probabilities. However, courts have on occasion sought to insert another burden of proof type between the criminal and civil standards, because the existing sanctions are deemed so punitive or severe that they put the individual's integrity in jeopardy. In some cases, civil liability could include a criminal wrongdoing, such as the breach of fiduciary duty. Therefore, the court needs to determine the appropriate standard of proof. However, following decisions make it apparent that it is very difficult to strike an appropriate balance. According to Denning, there is no absolute standard in civil or criminal cases. Though the civil standard is based on a preponderance of probability, he suggests that there are degrees of probability. For example, a fraud case naturally requires a higher degree of probability than that required if one were establishing negligence. Notwithstanding this point, he qualifies his statement by indicating that the degree of probability would not be as high as that expected in a criminal court.[44] This principle was observed more cautiously by Denning in the case of *Hornal*, where his Lordship decided that when a civil case consists of an allegation of criminality, the standard should still be based on

[43] L M Benson, 'Denying the Guilty Mind: Accounting for Involvement in a White-Collar Crime', Vol. 23, No. 4, *Criminology*, (1985) at p. 583-608
[44] *Bater v Bater* 2 All ER [1950] 458 at p. 460

a balance of probabilities, otherwise it would bring the civil process into contempt.[45] According to Coleman J in *Heinl*, when dishonesty is alleged, the standard of proof to establish dishonesty, although not as high as the criminal standard, should involve a high level of probability.[46] Notwithstanding the above decisions, *Re a Solicitor*[47] and *ex parte Austin*[48] go further and suggest a criminal standard may apply. For example, in *Re A Solicitor*, a case involving the striking-off of a solicitor from the roll of practitioners, it was held that the proceeding of a tribunal should apply the criminal standard of proof because the allegation of misconduct in the case was tantamount to a criminal offence.

The decisions in *Re A Solicitor* and *ex parte Austin* assert when a Tribunal considers a person's future position or professional integrity it is crucial that the standard of proof equates to 'beyond reasonable doubt'. This is because, like criminal sanctions of imprisonment, they banish individuals from the society they function within. Tribunals in some cases have adapted the higher civil standard when allegations were very serious.[49] However, it is crucial in such cases that, when devising regulatory offences that are traditionally criminal offences, they are not diluted to become civil actions which would be an abuse of process. Secondly, though the criminal law is outside the jurisdiction of a Tribunal, some civil and criminal sanctions are similar. In such cases, a safety-net needs to be present and not left for an appeal-decision to determine whether a criminal standard should be discharged.

### 5.6 The Evolution of the Bank's Enforcement Style

Banking acquired its own style of enforcement, traditionally referred to as 'moral suasion/persuasion'. Its *modus operandi* were, colloquially, the 'raising of the governor's eye-brow' to ensure control and discipline within the small and exclusive banking community. The Bank's enforcement policy and its regulatory authority

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[45] *Hornal v Neuberger Products Ltd* [1957] 1 QB 247 at p. 254
[46] *Heinl and Others v Jyske Bank (Gibraltar) Ltd* The Times Law Reports 28th September [1999] 661 at p. 662
[47] *Re A Solicitor* [1993] 1 QB 69 at p. 82 emphasis was given to a number of Commonwealth decisions, in particular *Bhandari v Advocates Committee* [1956] 1 WLR 1442 at p. 1452 at p. 81 "... in every allegation of professional misconduct involving an element of deceit or moral turpitude a high standard of proof is called for, and we cannot envisage any body of professional men sitting in judgement on a colleague who would be content to condemn on a mere balance of probabilities."
[48] *R v Milk Marketing Board, ex parte Austin* The Times Law Reports, 21st March (1983) 202 at p. 202

evolved as parallels, as a *laissez-faire* approach to supervisory style. Concern about the traditional enforcement by moral persuasion arose because of its lack of the clarity that rules provide, and the lack of transparency, both of which raise the possibility of arbitrary decision making.[50] Yet the Report on Banking Supervision, which culminated in the Banking Act 1979, highlighted that the flexible nature of the UK's supervisory regime was an essential factor in the growth of the City 'as the world's pre-eminent international banking centre'.[51] The formalisation of banking regulation and supervision with the introduction of the Banking Act 1979, and later the Banking Act 1987, which codified regulation and enforcement, ensured that authorised institutions complied with Schedule 3 of the Minimum Criteria for Authorisation. Although regulation and supervision was formalised, an anti-formalist approach continued to be dominant.[52]

Moral suasion in banking *per se* has a very long history, especially in periods of financial crisis. In such circumstances, the Bank would exercise its role of Lender of Last Resort to maintain financial stability in the banking system.[53] This role, in many respects, provided the leverage required to ensure that the use of moral suasion as a form of control was observed.[54] The importance of moral suasion also filtered into the justification for avoiding a rules-based enforcement policy.[55] It was the Bank's discretion, which was not subject to formal rules, whether support was given through the Lender of Last Resort function. The support provided was never by way of legal obligation to the market or its participants; it developed from a moral obligation which stemmed from the Bank's position as the central body for note issuance. Banks came to rely on the Bank as the central facilitator of finance and had

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[49] See SFA, Summary of the Findings of the Disciplinary Tribunal relating to Ian Hopkins (former Barings director) Press Release 11th March 1997 at p. 3 para., 2.3

[50] C Hadjiemmanuil, *Banking Regulation and the Bank of England*, London, Lloyds of London Press (1996)

[51] *Banking Supervision*, London, HMSO (Cmnd 9695) December 1985 at p.8 para, 4.5. *Report of the Committee set up to Consider the System of Banking Supervision*, (Cmnd 9550) London HMSO (1985) at p. 3, para., 2.1. (Leigh Pemberton Report)

[52] I Robinson and R Hussey, 'Formalism or Anti-Formalism: Regulation and The Bank of England', Vol. 3, No. 2, *Journal of Financial Regulation and Compliance*, (1995), 129-134

[53] See Chapter 2, The Role of the Bank of England and the Financial Services Authority

[54] K Dowd, 'The Evolution of Central Banking in England, 1821-90', 159-195 in F Capie, et al editors, *Unregulated Banking: Chaos or Order?* London, Macmillan (1991)

[55] Arthur Andersen & Co SC, *Findings and recommendations of the review of Supervision and Surveillance*, 24th July (1996), at p. 5, para., 28

to co-operate in order to survive. Although the moral obligation was voluntary, the underlying force behind the potential sanction was very strong.[56]

> "*The ultimate sanction the Bank held was to close a banks account at the Bank which would of guaranteed its demise at the time of the Baring crisis...[governor] Mr Lidderdale, who with characteristic decision, sent for the manager and informed him that if the bank did not adhere loyally to the agreement he would close its account at the Bank of England and announce the fact in the evening newspapers.*"[57]

According to Dowd, management would have felt some form of goodwill to the Bank when in times of crisis it came to their rescue.

> "*We lent by every possible means and in modes we had never adopted ... In short, by every possible means consistent with safety of the Bank; and we were not on some occasions over nice ... we rendered every assistance in our power. (Jeremiah Harman, a Bank spokesman, speaking about the Bank's role in the 1895 panic.)*"[58]

The clearing banks always provided a forum for policy making for the Bank, in which the Treasury was always at the forefront of developing government monetary policy. Clearing banks established their own club, which, some would say, amounted to cartelisation. They also operated as the important factor, whereby compliance with monetary policy was secured. In other words, in their own interest, the banking club ensured mutual respect of those who developed monetary policy so that financial markets would not be disturbed. The importance of co-operation in the running of a good financial market became manifest in the degree of co-operation between the banking community and the Treasury. The Bank and financial institutions recognised the mutual benefits of co-operating. According to Aledheff, the Bank gave the cartels more than tacit approval: it integrated the cartel and its agreements into the mechanism for conducting monetary policy.[59] The financial institutions recognised the benefit of co-operation and the effectiveness of moral suasion because, even

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[56] E T Powell, *The Evolution of the Money Market, 1385-1915*, London, Frank Cass & Co (1966) at p. 526-7 cited in K Dowd, (1991) op.cit., 53

[57] K Dowd, (1991) ibid., at p. 165

[58] H D Macleod, 'A History of Banking in Great Britain', in W G Summer, *A History of Banking in all the Leading Nations, Vol. II*, New York, Augustus M Kelley 1896 (re-printed 1971) p. 123. Cited in K Dowd, (1991) at p. 167

though the relationship was informal, the institutions did not 'ever forget there being an iron hand inside the glove'.[60]

Moral suasion as an enforcement style was not unique or exclusive to the Bank. It evolved over its history as an underlying tenet of its supervisory philosophy and remains the central tenet of banking regulation and supervision, even though its sophistication and intensification in terms of prudential supervision and expectation of the regulated has changed.[61] From the early history of the Bank to the present day, the approach has been compliance-orientated. From the development of regulation through to its enforcement policy, the underlying nature of such an approach was co-operation and trust between the Bank and the banking industry, with the Bank holding the ultimate power of revoking banks' right to undertake banking business. The nature of this enforcement strategy was to ensure observance through formal suasion.

### 5.7 The Impact of Bank Failures

The Reports and Inquiries into bank failures had brought into question the Bank's ability to identify the 'amoral calculator' or the 'organisational incompetent' such as JMB, BCCI and Barings. Public pressure has, on occasion, brought into question the Bank's reliance on the compliance-based strategy and the co-operation it seeks from institutions. It is doubtful whether the present strategy under the Banking Act 1987 catered for such a diverse industry – one that may require a range of intervention strategies to combat non-compliance. Bank failures highlight ; the lack of trustworthiness and co-operation from some institutions.[62] This was first brought to the fore with the collapse of Johnson Matthey Bankers (JMB), resulting from management failures that were not reported to the Bank.[63] Highlighting the problem of over-reliance on compliance which focuses on a large degree of co-operation and mutual trust as an enforcement style. According to Leigh Pemberton, banking

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[59] D A Alhadeff, *Competition and Controls in Banking: A Study of the Regulation of Bank Competition in Italy, France, and England*, Berkeley and Los Angeles, University of California Press (1968) at p. 314

[60] 'The Banks and their Critics: Argument with John Thomson', *The Economist*, September 4, (1965) 897-900, at p. 898

[61] See Chapter 3 Legal Aspects of Prudential Supervision

[62] D Singh, 'Misfeasance in public office: the case of banking supervision and BCCI', Vol. 6, No.4, *European Financial Services Law*, (1999), 128-135

[63] Bank of England, 'The Bank's Supervision of JMB', 35-42 in Bank of England, Bank of England Report and Accounts, (1985)

supervision could be improved upon without changing the style of enforcement, because it is not 'fundamentally flawed'. The Bank was advised to focus on the degree to which it should trust and co-operate with banking institutions. It was suggested that supervisors should have 'adequate powers to deal with cases where co-operation is not forthcoming',[64] and to encourage management to bring their concerns to the Bank earlier.[65] According to the report, 'JMB's position as a recognised bank was a factor in the delay in the supervisors becoming aware of, and reacting to, its growing problems'.[66] This was in contrast with licensed institutions, where a more rigorous regulatory and enforcement policy was formalised, due to the misconception that co-operation with these institutions would not be forthcoming because they were not in the main stream of banking. In many respects, this problem is persistent and an underlying theme in the Bingham Inquiry on how regulation can 'ensure that supervisory law, principles and practice generally create conditions hostile to the growth of fraud and friendly towards its early detection and eradication'.[67] Bingham LJ (as he then was) endorsed the conclusion of Leigh Pemberton about not overhauling the system of banking supervision by incorporating an intensified approach, as any other approach was considered to place a heavy burden on the good and reduce the resources required to detect the bad. The substitution of a code of detailed rules for a system based on the use of informed judgement is not considered the answer[68] because, for some, supervisory judgement can legitimately mean not 'invoking the law'.[69] The criticism of the Bank has been relatively minor in comparison with the general consensus in support of its style of banking supervision, which called for the improvement of its judgement but not an overhaul.[70]

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[64] Leigh Pemberton Report, (1985) op. cit., n. 51, at p. 3 para., 2.3
[65] 'The Bank's Supervision of JMB', (1985) op.cit., 63, at p. 36
[66] Leigh Pemberton Report, (1985) op. cit., n. 51, at p. 4, para, 3.3
[67] The Right Honourable Lord Justice Bingham, *Inquiry into the Supervision of the Bank of Credit and Commerce International,* London, HMSO July (1992) at p. 182, para., 3.8 (Bingham Report)
[68] Ibid., at p. 181, para., 3.2
[69] See Brian Quinn response to Q. 215 and 216, HC (1991-92). A rules-based approach would, in the case of BCCI, expose the bank to adverse market opinion which may have been more detrimental to depositors than attempting to allay support from its shareholders.
[70] Report of the Board of Banking Supervision Inquiry into the circumstances of the collapse of Barings, Return to an order of the Honourable the House of Commons dated 18th July 1995 at p. 251, para., 14.4

### 5.8 Discretion and Transparency in Banking Supervision

Transparency in enforcement is normally considered paramount in order to indicate to the regulatory community that regulation is implemented consistently and proportionally. The opacity and lack of enforcement activity has been traditionally justified on the grounds of safeguarding the interests of depositors and the concerns surrounding systemic risk where the failure of one bank could place in danger the solvency of other related institutions.[71] While concerns about financial stability exist, argument for opacity does have limits, and it is questionable whether it is feasible in the majority of enforcement decisions, simply because the enforcement style and sanctions utilised by other regulatory bodies to which the various components of a bank financial conglomerate are exposed to negate such reasoning. Moreover, the very fact that the US regulatory enforcement involves a wide range of publicised sanctions indicates that the traditional perception of the vulnerability of banks is not plausible in today's society.

Although the discretion-based approach adopted by the Bank was generally supported, concerns about transparency were prevalent.[72] The transparency in the work of other agencies undertaking investigations into authorised institutions did cause concern for the Bank, and in many respects made the Bank very nervous about such actions. This arose particularly with the DTI's investigation into the fraud surrounding the Blue Arrow affair, which involved the take-over of Manpower. The case involved a subsidiary of National Westminster Bank called County Natwest Ltd (CNW). The investigation raised concerns about the role of CNW in fraudulent activities.[73] The public nature of the Inspectorate was of particular concern to the Bank, which felt that the matter was better dealt with between the Bank and the DTI, because of the position of bank which was at the 'pinnacle of the financial establishment'. According to the Governor of the Bank:

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[71] C A E Goodhart, 'Some Regulatory Concerns', Special Paper No. 79, Financial Markets Group, London School of Economics, December 1995 at p. 16

[72] B Quinn, 'Rules v Discretion: The Case of Banking Supervision in the light of the debate on Monetary Policy', Special Paper No.85, *LSE Financial Markets Group* an ESRC Research Centre, Special Paper Series, July, (1996), 1-13 at p. 4

[73] Report by M Crystal QC, D L Spence CA and V Temple, *National Westminster Bank PLC.* Investigation under Section 432(2) of the Companies Act 1985, London, Department of Trade and Industry HMSO 20th July (1989) (DTI Report)

*"Banking Supervision was still hoping that we might be able to deal with this ourselves but... they were also beginning to wonder whether it was not rather more wide-ranging than we had appreciated. As it, ... came into the public domain it was going to be more and more difficult to deal with this, as one might say, between ourselves, the Bank of England and National Westminster, simply because of the public interest and I suppose [the] thought [that] there might be a cover-up."*[74]

The public was quick to perceive regulatory capture, which was later held to be unsubstantiated, when the allegations from the investigation centred around the Bank hindered its completion. Furthermore, the episode brings into question the opacity of its enforcement activities and investigations process, thus undermining in many ways the public interest in such affairs. Due to its policy of safeguarding the interests of depositors, it placed ~~s~~ the threshold of public interest at an unreachable level before disclosure was made. The justification for adopting such an approach is further cemented by Mr Quinn's statement to the investigation. According to Quinn, the Bank's style of supervision preferred to avoid official investigations into banks in order to safeguard confidence within the institution, which could be undermined if knowledge of an investigation became public. The Bank's approach would have been to allow Natwest to undertake a thorough internal investigation.

The evidence given by the Governor and Mr Quinn clearly highlights the distinct approach adopted by the Bank in terms of preventing disclosure of potential problems that could undermine confidence in the institution, rather than ensure that the allegations are thoroughly resolved and the action taken publicised. Moreover, the evidence to the investigation provides some light on the force of moral suasion through Natwest's discussions with the Bank and the method used to ensure compliance.

*"Although there was no overt criticism clearly the time devoted to the topic and the nature of the questioning left us feeling we had suffered the 'eyebrow raising treatment'...There was no 'overt criticism' at that meeting but the discussion and questioning had been of a serious nature... There was no doubt about it that one felt it was like being in a headmaster's study on this occasion ...We got the impression that they were unhappy with the way things developed. The investigation and the failure in submitting an appropriate*

[74] Ibid., at p. 120

*report into the affair eventually culminated into an investigation and appointment of inspectors at CNW."*[75]

The Blue Arrow episode highlights the reluctance to publicise problems at authorised institutions and to avert undermining confidence within the industry, the very lynch-pin that holds the markets together. It would rather exercise appropriate remedies within the confines of its own supervisory remit than expose problems, which would be like signing its death warrant.

### 5.9 The Enforcement Style of the Financial Services Authority

As highlighted earlier, banking business is not regulated solely by the Bank, even though it may act as Lead Regulator; other regulatory and prosecution bodies have powers of investigation and enforcement.[76] Under the Financial Services Act 1986 the powers of the SRO consist of enforcement powers to regulate particular types of investment business. This means that banks are exposed to various types of enforcement powers over and above those under the Banking Act 1987. This is notwithstanding the powers of Department of Trade and Industry (DTI), under section 432(2) of the Companies Act 1985 to investigate the affairs of those institutions incorporated under it. The Serious Fraud Office (SFO), established in 1988, also has wide enforcement and investigation powers; it draws a large proportion of its powers from the Criminal Justice Act 1987 and is responsible for the prosecution of cases involving complex fraud and are of public concern and require specific expertise to deal with the case. As one can see, a number of bodies existed with various agendas to investigate and prosecute regulatory malpractice.

### 5.10 Enforcement Style and s. 16 1987 Act - Statement of Principles

The Bank's enforcement compliance-based strategy of suasion was based on the idea of remedy, and the FSA adopted the same policy position. The literal definition of a 'remedy' connotes 'compliance', in which the underlying ideas are 'treatment' or 'a means of counteracting or removing anything undesirable' or 'rectify

[75] Ibid., at p. 130
[76] N Walmsley, 'Enforcement', in A Haynes (ed), *The Butterworths Financial Services Law Guide*, London, Butterworths & Co. (Publishers) Ltd (1997)

and make good'.[77] The definition brings to the fore the foundations of a compliance-based approach for enforcement. Moreover, the very word 'enforcement' is rarely used in the guidance notes or the revised Statement of Principles by the FSA (Principles). The Principles distinguished between situations of mandatory revocation and those cases which consist of problematic issues in authorised institutions. The Statement advocates the need for flexibility in dealing with such cases by giving the FSA discretion to decide whether to revoke or restrict the authorisation, or seek remedial action by some other means, such as persuasion and encouragement. In such circumstances, the FSA would require the authorised institution to take adequate and speedy steps rather than restrict or revoke authorisation, for example, by injecting new capital or appointing new directors.[78]

The Principles indicated that persuasion and encouragement were used to ensure compliance and make sure that the authorised institution undertook actions to 'rectify' or 'remove anything undesirable'. According to the Principles (para. 6.4), it could mean allowing the authorisation to continue so that the remedy needed can be explored, rather than revoking the authorisation and risk losing depositors' money.[79] This is highlighted by the Bank's enforcement decisions in *Hall v Bank of England*, [80] where the allegations of misfeasance in public office failed. The Halls undertook deposit-taking as part and parcel of their property-management company. Through continuous supervision, the Bank was of the opinion that the companies assets, records and systems were not sufficient to safeguard the interests of its depositors and potential depositors. The proposals to rectify included changes to the management of the company, restrictions on advertising and accepting deposits, and later, sale of unoccupied properties to safeguard the company's assets. The case points out that the idea of 'remedy' is not a cosy arrangement between the regulator and regulated, and that the proposals that led to the surrender of authorisation were to avoid the public humiliation of having their authorisation revoked.

[77] D Thompson (ed), *The Oxford Compact English Dictionary*, Oxford, Oxford University Press (1996) at p. 857

[78] FSA, Statement of Principles, (1998) op. cit., n. 4, at p. 39, para., 6.3

[79] For an overview on when to intervene see, R Baldwin & M Cave, *Understanding Regulation: Theory, Strategy and Practice*, Oxford, Oxford University Press (1999) at p. 107

[80] Unreported Court of Appeal decision, Hall v Bank of England Wednesday 19th April 2000 CHANI1999/0854/A3 CH1997 H 544

The Bank's favouring 'reconstruction and reform' came under criticism from the Treasury Select Committee after the closure of BCCI. The Committee suggested that this does not necessarily mean that a regulator should be excused from ensuring that the Criteria for Minimum Authorisation are continuously met.[81] Therefore, the Committee recommendations swing the enforcement pendulum to a deterrence-based approach, which views 'reconstruction and reform' as an alternative to punishing 'non-compliance', but, as shown above in the case of *Hall*, reconstruction can be a deterrent mechanism.

According to the Arthur Andersen Report (Report), the style of supervision conducted by the Bank was effective because it used persuasion and not just the force of law to resolve problems at individual institutions.[82] Parties interviewed by Arthur Andersen suggested there were merits in the discretion-based approach within a confined remit. The Report compared the rates of failure in various jurisdictions, e.g. the US, and found that the UK supervisory approach faired much better than those jurisdictions which utilised a rules-based approach. Moreover, in terms of cost of supervision, institutions found those advocating a rules-based approach were more expensive.[83] The Report suggests that alternative sanctions are limited in their use and are not appropriate for prudential regulation.

> "*Many S&S supervisors and institutions feel that supervisors are not making appropriate or sufficient use of supervisory actions. They have 'nuclear options' in restrictions and revocation, which are, by definition, limited in their application. However, they make too little use of intermediate levers, most notably changes in target and trigger ratios or more intensive supervision. Institutions' experience is that changes to target and trigger levels, which dilutes their effect, as there is no impact on the business's scope or level. Supervisors may also be hesitant about applying more intensive supervision which often imposes greater cost on the institution, for example by scoping section 39 more widely or requiring more frequent information.*"[84]

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[81] The Treasury and Civil Service Committee, *Fourth Report, Banking Supervision and BCCI: International and National Regulation*, HMSO (1992) at p. xviii, para., 40

[82] Arthur Andersen Report, (1996) op. cit., n. 55, at p. 5, para., 28

[83] Furthermore, Arthur Andersen Report raises the concern about the possible expectations gap which can arise if a rules and inspection based approach were to be implemented. Arthur Andersen Report, (1996) op. cit., n. 55, at p. 4, para., 20

[84] Arthur Andersen Report, (1996) op. cit., n. 55, at p. 20, para., 107

Furthermore, it noted that many parties felt that the Bank had at its disposal enforcement sanctions of the 'nuclear options', thus highlighting the concern of over-punitive sanctions with little middle-ground, such as changes to the 'target' or 'trigger ratios', or more intensive supervision. These sanctions were only utilised when the capital of the authorised institution was far above the target ratio. Therefore, the decision to increase the target ratio would only have a nominal retributive effect. Moreover, cost concerns also seem to override what may be deemed effective vigilance of the authorised institution. The discretion-based approach allows the regulator flexibility to undertake numerous enforcement actions, provided they are exercised reasonably.

**5.11 The Financial Services and Markets Act 2000**

The FSA under the FSMA 2000 consolidates the enforcement powers of the various regulatory bodies, which means the exercise of a number of powers that deposit-taking institutions have not traditionally been exposed to. The establishment of a single regulator also means a single enforcement-style rather than the plurality of approaches that govern the various facets of the financial services industry. It is *prima facie* reasonable to assert that the adoption of a single approach could lead to teething problems, in particular, an enforcement style that could be over-or-under inclusive, depending on which enforcement tradition one previously existed under. This would lead to the situation that a quasi-enforcement style similar to that adopted in the regulation of investment business will regulate activities governed by the Banking Act 1987, and raise the concern, highlighted in the Arthur Andersen Report, that the banking industry will be over-enforced or sanctioned.[85]

The powers under the FSMA 2000 cover a broad range of activities, not simply the authorised firm or approved person; it also covers third parties involved in the regulatory and supervisory process, e.g. auditors.[86] First, it is based on an 'open and co-operative relationship between the FSA and those whom it regulates'. [87] While this principle is not new, it highlights the regulator's preferred style of ensuring

[85] Arthur Andersen, Report, (1996) op. cit., n. 55, at p. 20
[86] FSA, Handbook Enforcement Manual 2001; see also, FSA, *The Enforcement Manual*, Consultation Paper 65, August (2000)
[87] FSA, ENF, s. 1.3.1 (1); see also FSA, *Meeting our Responsibilities*, August (1998) at p. 56, para., 225

compliance within the industry. This means enforcement powers will only be exercised when the compliance-based approach of openness and co-operation is not forthcoming, and exercising enforcement action is the only way of effectively addressing regulatory failure. This approach echoes the initiatives Leigh Pemberton and Lord Justice Bingham encouraged in their attempts to reform banking supervision. Secondly, it is based on 'the exercise of the FSA's powers in a manner that is transparent, proportionate and consistent'.[88] The discretion is legitimated and prevalent, and will be based on the notion of fair treatment, transparency of decision making, proportionality of enforcement sanctions and consistency between authorised institutions. Finally, the principle that underpins the FSA's enforcement policy is, 'fair treatment when exercising its enforcement powers'[89] and this provides the benchmark to measure whether the FSA is 'fair' and 'is seen to be fair'.[90] The FSA in the majority of instances will not utilise enforcement sanctions but rather propose to assist with the remedial action agreed upon with the firm, or issue a private warning where remedial action has been taken.[91] These ideas highlight the basis for structuring discretionary decision-making and assist in avoiding the concerns about ~~of~~ arbitrary/subjective decision-making which undermined the validity of exercising judgement in banking supervision.

The Regulatory Decisions Committee (RDC) will be the most prominent and influential body to make up the new framework. This is because the enforcement style adopted will be the barometer in terms of the response of the regulated and the consumer. The setting up of the new committee will separate regulation from enforcement decisions and mean a reduction in the conflict of interests that could arise between regulation/supervision and enforcement.[92] The initial role for the RDC, referred to as the 'Enforcement Committee', was quasi-judicial to enhance the credibility of the FSA enforcement decisions, but this conflicted with the role of the FSMA Tribunal.[93] It would be premature to designate the RDC as judicial because an

[88] Ibid., s.1.3.1.(2)
[89] Ibid., s. 1.3.1.(3)
[90] FSA, Consultation Paper 17: *Financial Services Regulation: Enforcing the New Regime*, (1998)
[91] Ibid., s. 1.3.4; see also FSA, Chapter 11 Discipline: The FSA's general approach, (2001) at s. 11.3; for background see, FSA, CP 65 (2000) op. cit., n. 87
[92] FSA, CP 65, (2000) op. cit., n. 87, at p. 15
[93] FSA, *Response to Consultation Paper 17: Financial Services Regulation: Enforcing the new regime*, July (1999), at p. 6; see changes FSA, CP 65, (2000) op. cit., n. 87, at p. 16

enforcement committee is usually for enforcing sanctions in the event of violations and no judicial power is exercised in so doing, and because examples will be required to justify that title.

The RDC is to be made up of members with experience of the industry and representing the industry and consumers. The RDC is a body outside the FSA's management structure but is accountable to the Board of the FSA for its decisions.[94] The RDC is not a statutory body like the Practitioner Panel or the Consumer Panel, even though it does exercise enforcement powers under s.395 of the FSMA 2000, where the roles of decision-making and evidence-gathering are distinguished. While it is very early days, the establishment of a separate and independently constituted committee is a significant change avoiding the conflict of interests that could arise from regulation and enforcement. It will avoid concerns about regulatory capture (with its introduction of independent parties on the committee) that has permeated the regulation and supervision of banking. However, this is not to say that potential for conflicts of interests does not remain in enforcement actions. For example, certain prudential measures will not be made by the RDC but by executive procedure, a committee consisting of senior FSA staff.[95]

The RDC has responsibility for making a broad range of enforcement-decisions that regulate the permission to undertake authorised activities. For example, it can impose limits and requirements, and restrict or prohibit regulated activities.[96] However, prudential matters will be performed by executive procedures such as regular reporting or set requirements governing large exposures.[97] These responsibilities will entail the issuing of Warning Notices,[98] Decision Notices[99] and in some cases, Supervisory Decisions.[100] The FSA is required to issue a Warning Notice indicating the reasons for initiating the action, identifying the misconduct deemed to have taken place, and the proposed sanction to be imposed. The FSA would then proceed with a Decision Notice that will outline the decision and state when it will

[94] FSA, Chapter 4, *The decision maker*, (2001) s. 4.2.1-4
[95] Ibid., 4.3.1
[96] Ibid., s. 4.1.4-5
[97] Ibid., s. 4.1.8
[98] FSMA 2000, s. 387
[99] Ibid., s. 388
[100] Ibid., s. 394

take effect. The approved firm or person will have the right of appeal to the Appeals Tribunal set up under the regulatory regime.[101]

### 5.12 The US Experience of Enforcement

Occasionally, it is difficult to emulate practices from abroad because of the economic and cultural factors that mould a particular regulatory order. However, to assess impact of policy, it is possible to learn from differing experiences. The US structure of banking regulation is unique in that there are a number of regulatory agencies with responsibilities ~~of~~ for safeguarding the whole banking system. In the US, the Federal Reserve is one of a number of bank regulators, the others being the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS). There are also a number of other regulatory bodies which have responsibility for the banking and thrift industry. However, in terms of enforcement policy and rules, the legal structure is far more centralised. The enforcement powers that exist today are the consequence of various financial disasters. These financial failures brought the discretionary/persuasion-based approach in banking regulation into question, thus raising the criticism that it was outmoded. This is notwithstanding the fact that Davis advocates the approach as 'probably the outstanding example in the federal government of regulation of an entire industry through methods of supervision'.[102] The criticism resulted in greater use of formal enforcement-actions and the imposition of sanctions by the various regulatory bodies, and a move away from the come-let's-reason-together approach.[103] However, the evidence from the US does suggest that a discretionary enforcement-policy could, on the other hand, lead to very extreme measures, such as the displacement of the entire management of an institution without direct statutory authority.[104]

101 FSA, Chapter 5. References to the Tribunal, publication and service of notices (2001)

102 K C Davis, *Legal Times*, October 25 1982, cited in J D Hawke Jr, *Commentaries on Banking Regulation*, Washington DC Harcourt Brace Jovanovich, Publishers (1985) at p. 51

103 J D Hawke Jr, (1985) at p 51; see also: L G Baxter. 'Judicial Responses to the Recent Enforcement Activities of the Federal Banking Regulators', Vol. 59, *Fordham Law Review*, (1991) 193-242; L G Baxter, 'Fiduciary Issues in Federal Banking Regulation', Vol. 56, No. 1, *Law and Contemporary Problems*, Winter, (1993), 7-39

104 *Miami Beach Fed. Sav. & Loan Ass'n v. Callander*, 256 F.2d 410, at p. 414-415 (5th Cir.1958)

The Financial Institutions Reform, Recovery, and Enforcement Act 1989 (FIRREA) was enacted to deal with a number of failures exposed by the US Savings & Loans disaster and consequently provided much wider enforcement powers to banking regulators.[105] The FIRREA has built on the move away from persuasion and greater use of formal enforcement sanctions. FIRREA provides a broad right to initiate enforcement sanctions against not only institutions and their employees, but also against third parties such as accountants, lawyers and affiliated parties. It builds upon the existing regime by providing various formal sanctions to ensure compliance and act as a deterrents. The Federal Reserve has a number of enforcement options, formal and informal powers, which can be further divided into enforcement actions that are publicised and those that are not. The enforcement powers consist of:

- Bank Board Resolutions
- Memorandum of Understanding
- Cease-and-Desist Orders
- Suspension, Removals, or Prohibitions of Individuals
- Civil Money Penalties
- Suspension or Termination Orders
- Placement in Conservatorship or Receivership.

Both Bank Board Resolutions (BBR) and Memoranda of Understanding (MoU) are enforcement actions that are informal and are not publicised. The BBR is essentially a resolution adopted by the board to implement reforms deemed necessary by the Federal Reserve. This enforcement sanction is essentially adopted in cases where it is considered that the matter is not serious and can be resolved by the institution itself. The MoU builds on the former resolution in terms of actions, the Federal Reserve produces its own action-plan, which the institution then complies with. Again, this enforcement action is deemed informal and is not publicised. However, the approach changes with formal enforcement actions that are publicised. These are essentially deemed to be serious problems that affect the safety and soundness of an institution or punish non-compliance with regulatory rules. The key one is the Cease and Desist Order (C&DO), which is issued after an official hearing

[105] A C Providenti Jr, 'Playing with FIRREA, not getting burned: statutory overview of the Financial Institutions Reform, Recovery and Enforcement Act of 1989', Vol. 59, *Fordham Law Review*, (1991), 323-338 at p. 333

and is effective until remedial actions have been taken. They are also issued when a problem is considered to make the institution unsafe or unsound in terms of banking practices, such as violations of Federal or State laws and regulations, and violations of any written directive from the regulator. The order not only prohibits particular activities but also specifies actions to rectify the problems. Action that is more punitive is also available both in terms of publicity and issue of civil money penalties. Under FIRREA 1989 the monetary fine can be in the region of $1 million dollars a day. (Fines can range from $1,000 - $25,000 a day.) The level of the fine relates to the seriousness of the failure, the question of recklessness and/or breach of fiduciary duty, and the gain to individuals or institutions.

A central policy concern for all bank supervisors is ensuring a safe and sound banking environment, and it requires an appropriate mix of enforcement sanctions. The use of publicity is another addition to the enforcement-mix of sanctions. There is clear recognition that the draconian power-of-termination is analogous with ~~to~~ wielding a blunt instrument in a surgical procedure that really requires a more refined tool. The US experience shows that the UK's approach of treating banks within an informal, opaque environment is essentially misconceived, and in many respects undermines the importance of utilising market response as a mechanism of ensuring compliance. Studies in the US into the effect of their formal enforcement show that institutions implement the steps required. More importantly, the effect on market discipline of the publication of formal enforcement-actions can, without necessarily leading to their demise, harm the equity prices of listed institutions.[106]

### 5.13 The Banking Act 1987 and Sanctions

Under the 1987 Act, deposit-taking was restricted to those institutions which were so authorised.[107] Where the authorised institution did not comply with the supervisory regime the 1987 Act provided, a wide range of enforcement strategies

[106] J Peek and E. Rosenberg, 'Bank Regulatory Agreements in New England', *Federal Reserve Bank of Boston New England Economic Review*, May/June, (1995) 15-24. J E Peek, Rosenberg, and J.J. Jordan, 'The Impact of Greater Bank Disclosure amidst a Banking Crisis', Working Paper Series No. 99-1, *Federal Reserve Bank of Boston* (1999). S K Huber, 'Enforcement Powers of Federal Banking Agencies', 7, *Annual Review of Banking Law*, (1998), 123-179; and T Curry et al, 'Bank Examination and Enforcement', in FDIC, *History of the Eighties-Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s* http://www.fdic.gov/bank/historical/vol 1.html
[107] 1987 Act s. 3(1) Authorisation is discussed in Chapter 3 Legal Aspects of Prudential Supervision

obliged it to safeguard the interests of existing and potential depositors. The 1987 Act prescribed civil sanctions which could be utilised and non-compliance resulted in criminal sanctions. It also provided powers which allowed the Bank/FSA to monitor authorisation and prohibit activities which did not comply with their authorisation under the 1987 Act or the guidance it provided on such powers. The underlying purposes of these powers were to revoke,[108] restrict or impose conditions,[109] and in some cases, to undertake mandatory revocation and restrictions[110] on authorised institutions in order to ensure the safety of depositors interests. Statements made by persons purporting to describe themselves as authorised institutions led to criminal sanctions.[111] The 1987 Act also prohibited those who advertise or who procure deposits through unsolicited calls.[112] Moreover, those who fraudulently induced others into making deposits were also criminally liable.[113] The civil sanctions included the ultimate penalty of taking away the authorisation to conduct deposit-taking business for non-compliance with such a restriction or condition under the 1987 Act. They exposed an authorised institution to criminal penalties under s12(6) in order to ensure compliance with the restriction or conditions. The 1987 Act provided the Bank/FSA with the power to apply to the court for an order to repay deposits[114] and the profits[115] that accrued from the deposits that were in contravention of s.3. The 1987 Act also provided criminal sanctions for the unauthorised use of banking names and descriptions.[116]

The 1987 Act built huge discretion into the restrictions, conditions, and the directions that can be applied to an institution. These civil sanctions provided ammunition to ensure the authorised institution complies with the supervisory responsibilities it is required to observe under the 1987 Act. The powers of revocation and restriction are inter-dependent. The circumstances that raise a concern about an institution may not justify revocation, but require its restrictions to ensure that it repays its depositors. On the other hand, conditions could be placed on the business

[108] Ibid., s. 11
[109] Ibid., s. 12
[110] Ibid., s. 14
[111] Ibid., s. 18
[112] Ibid., s. 32
[113] Ibid., s. 35
[114] Ibid., s. 48
[115] Ibid., s. 49
[116] Ibid., s. 67

activities of an authorised institution to ensure it is prevented from undermining the interests of depositors by pursuing business activities deemed inappropriate for reasons such as lack of knowledge or sufficiency of capital.

Activities prohibited under the Act were essentially punished by criminal and punitive civil sanctions that attempted to deter such activities, hence the appropriateness of the metaphor 'nuclear options'. The statistics in this paper show the mixed propensity of the Bank/FSA to punish such activities.[117]

Table 1: *Banking Act 1987 Investigations of illegal-deposit taking*

| *Year* | Cases Investigated | *Injunctions and Petitions* | *Prosecutions* |
|---|---|---|---|
| 2001 | - | - | **2** |
| 2000 | **110** | - | **4** |
| 1999 | **128** | **5** | - |
| 1998 | 90 | **2** | - |
| 1997 | 70 | - | - |
| 1996 | - | - | - |
| 1995 | 52 | 2 | 1 |
| 1994 | 43 | - | 9 |
| 1993 | 30 | 4 | 2 |
| 1992 | 37 | 4 | 3 |
| 1991 | 26 | 4 | 3 |

The figures for the regulation and punishment of illegal deposit-taking in Table1 show the Bank/FSA to have a higher propensity to investigate and prosecute illegal deposit-taking business, which draws attention to the distinction between 'regulating authorisation' and 'continuous supervision with powers to restrict or revoke an authorisation'. This could be because the powers under the 1987 Act are not consistent. For example, the powers prohibiting illegal deposit-taking are more explicit and certain, providing less power to exercise judgement.

[117] These statistics have been gathered from a number of sources the yearly Bank of England, Banking Act Reports 1991-1997, FSA, Annual Reports 1998-2001and FSA, Press Releases 1998-2001-11-21. The enforcement actions taken by the FSA are indicated in bold.

Table 2: *Banking Act 1987 Revocations and Restrictions*

| *Year* | *Revocation of Authorisation* | *Restriction of Authorisation* | *Revocation of Restricted Authorisation* |
|---|---|---|---|
| 2001 | - | - | - |
| 2000 | - | - | - |
| 1999 | - | - | - |
| 1998 | - | 1 | - |
| 1997 | - | - | 1 |
| 1996 | - | 1 | - |
| 1995 | - | 1 | - |
| 1994 | 1 | 7 | 2 |
| 1993 | 3 | 12 | 2 |
| 1992 | 1 | 4 | |
| 1991 | 3 | 4 | |

This is in stark contrast with the powers regulating continuous supervision in Table 2, where the rules were couched in normative terms, consisting of greater power to exercise administrative discretion. The frequency with which the Bank exercised its powers of restriction and revocation shows its reluctance to exercise such powers. Hence these are a last-resort where other remedies may be appropriate. Furthermore, the figures show that the FSA has not adopted an enforcement strategy any different from that of the Bank.

It would be reasonable to assert that those restricted and revoked are merely the tip of the iceberg. Furthermore, the likelihood of such enforcement actions being exercised in the case of large banks is remote. These banks are deemed `too large to fail", which means that their closure would have such a damaging effect on the economy that the regulator would need to take steps to avoid it, even though this might lead to a greater propensity for larger banks to take on risk.[118] Finally, the frequency with which institutions are inclined to surrender their authorisation also

[118] F Sousa, 'Too Big to Fail: Moral Hazard and Unfair Competition', in L Halme, et al, *Financial Stability and Central Banks: Safety Nets and Market Discipline*, London, Bank of England (2000) at p. 7

shows the reluctance of institutions to have their authorisation revoked.[119] This could only mean that the adverse publicity from a revocation or restriction is so great that institutions would be reluctant to have such powers exercised.

**5.13.1 Interviews and Investigations**

This section is concerned with power of investigation and the power of enforcement given to the Bank/FSA by the 1987 Act. It is unfortunate that the FSA does not publish in its annual reports details about the number and type of interviews it undertakes with deposit-taking businesses: In not doing so it reduces the possibility of comparing its position with that of the Bank. The central weapon for ensuring compliance is the power to make regulatory visits and undertake prudential interviews. The more formalised visits/interviews focused on particular aspects of the minimum requirements for continuing authorisation. The use of on-site visits ensures that the authorised institution is in compliance. The Bank has traditionally suggested that the relationship built up with the institution provides it with an intimate picture, in particular its business objectives and an assessment of the capability of its management to control the business. The Bank would assert that the emphasis on a qualitative assessment provides the initial signs of management problems and inadequacies.[120]

The introduction of specific visits did not radically alter the underlying compliance-based approach and reinforced the idea that interviews were arranged with the permission of the authorised institution on a formal and voluntary basis rather than invoked through investigative powers. Even though the catalyst for the introduction of the visits was the concern in the early 80s about the deterioration of lending systems and assets of particular institutions, the underlying policy for such visits remains voluntary, in order to ensure good relations and to see the changing nature of the business of banking. The interviews were structured on two broad bases, 'routine' and 'non-routine' visits. The routine visits were normally to UK-domestic locations and to overseas locations where the authorised institution undertook its business or where its parent company was located. The non-routine visits were

[119] FSA, Annual Report 1999 at p. 33
[120] Bank of England, Report and Accounts for the year ended 28th February, Banking Act 1979, Annual Report by the Bank of England (1985/86) at p. 44

undertaken by a review-team of specialists seconded to the bank, such as analysts, bankers and accountants to review particular areas of interest. The duration of the visits ranged from two-to-three days to a week, depending on the complexity of the task. The review would either include the full range of activities or specific business and operational areas, internal control systems and procedures in authorised institutions. Whilst the figure for non-routine visits does seem high, a review-team would visit once every two to three years and so perform a very limited role in terms of regulatory assessment. After Barings, there were recommendations for another review-team, one specialised in the growing business of market-trading. The Traded Markets Teams was also included.

Table 4: *Banking Act 1987 Interviews and Visits Routine and Non-Routine*

| *Year* | *Interviews* | *Routine* | *Non-Routine* | *Visits* |
|---|---|---|---|---|
| 2001 | - | - | - | - |
| 2000 | - | - | - | - |
| 1999 | - | - | - | - |
| 1998 | - | - | - | - |
| 1997 | - | - | - | 218 |
| 1996 | - | - | - | - |
| 1995 | 3000 | - | - | - |
| 1994 | 3000 | 1200 | 1800 | 193 |
| 1993 | 3500 | 1000 | 2000 | 123 |
| 1992 | 3500 | 1500 | 2000 | 140 |
| 1991 | 3000 | 1000 | 2000 | 250 |

The Barings collapse highlighted concerns about the effectiveness of the meetings and the lack of probing questions into a number of regulatory areas, such as large exposure concessions, high profitability of particular business areas, and the lack of what may be termed 'regulatory scepticism' of the information submitted or discussed at those meetings[121]. Though a hostile approach is not actually advocated, 'regulatory scepticism' could be defined as an approach which is inquisitorial in

[121] Treasury and Civil Service Committee: Board of Banking Supervision The Report on the Collapse of Barings Bank. Minutes of Evidence Wednesday 19th July 1995. Bank of England. *Mr Eddie George, Mr Brian Quinn and Sir Alan Hardcastle* at p. 174

nature. The introduction of the risk-based approach suggests that effective use of routine and non-routine meetings will result. In such meetings, little regulatory investigation takes place, hence the criticism of the Arthur Andersen Report. The network of systems and controls can be so elaborate in terms of managing risk that when verification of the information is based essentially on senior management's judgement, the likelihood of detecting fraud in such a short space of time very remote.

Table 5: *Banking Act 1987 Use of Section 39 Reports and Section 17/41 powers*

| *Year* | *Section. 39 Reports* | *Special Reports* | *Section 17/41 powers* |
|---|---|---|---|
| 2001 | - | - | - |
| 2000 | - | - | - |
| 1999 | **334** | - | - |
| 1998 | **391** | - | - |
| 1997 | **482** | - | - |
| 1996 | - | - | - |
| 1995 | - | 11 | - |
| 1994 | 610 | 3 | - |
| 1993 | 620 | 4 | 3 |
| 1992 | 681 | 4 | 5 |
| 1991 | 728 | 1 | 4 |

Section 39 reports were commissioned by the Bank/FSA and were a routine part of the supervisory process. The Barings collapse highlighted a number of inadequacies in the traditional s.39 approach, and a number of improvements such as the risk-based approach were implemented. However, the underlying policy-concern still exists about the conflict of interests in the auditor and reporting-accountant being the same entity. Both s.39 and s.41 were operative in deciding whether authorisation should be revoked or restricted. Therefore, a concern arises as to the significant reduction in the use of s.39 Reports from 1997, with the introduction of the risk-based approach.[122] The underlying reason suggested for the reduction is the lower number of bank authorisations, but this reason is inadequate in comparison with the growing complexity of banking. Furthermore, the decrease in s.39 Reports is legitimated by the FSA on the grounds of reducing the cost of compliance, but this justification does not reflect the concerns raised by the Barings Report. Section 41 reports were utilised when serious concerns arose which could threaten the interests of depositors. The statistics highlight that s.41 reports were rarely initiated and this is confirmed by the statistics relating to revocation and restriction.

One has to accept that, in the process of carrying out supervision, a degree of accommodation of certain minor departures from the regulations might be necessary. These departures are tolerable and may need to be accommodated in order to avoid undue and adverse affect on the market and disturbing the rapport between the regulator and the banks. Over-accommodation of derogation as suggested by Bardach and Kagan, should be looked at from a pragmatic standpoint. What matters most is the nature of the derogation that is accommodated. No sensible regulatory body should accommodate a derogation of a significant nature that can have adverse repercussions on depositors. JMB, BCCI and Barings confirm this.

**5.14 FSA Enforcement Sanctions**

The FSMA 2000 provides a framework for authorising persons to carry on regulated activities and gives Treasury the responsibility for to introducing the Regulated Activities Order to flesh-out the provision and replace the Banking Act 1987. Under the FSMA 2000, the authorisation system is more elaborate even, though it is based on the ethos of the 1987 Act. First, it prohibits those unauthorised from carrying on regulated activities; secondly, a number of ways exist to be authorised; thirdly, permission is granted to carry on regulated activities provided there is conformity with prudential supervision.[123]

The FSMA 2000 provides the FSA with powers to control entry to and exist from the financial markets whether voluntarily or through coercion.[124] The FSMA 2000 introduces another cog to the authorisation machine: permission.[125] The

[122] FSA, Annual Report 1999/2000 'Report of the Managing Director and Head of Financial Supervision', at p. 19
[123] FSMA 2000 s. 19-23 and in particular s. 29
[124] Ibid., Part IV 'Permission to Carry on Regulated Activities' s. 40-55
[125] Ibid., s. 40

application for Part IV permission requires satisfaction of the 'threshold conditions' in Schedule 6 on a continuing basis.[126] These equate to Schedule 3 Minimum Criteria for Authorisation under the 1987 Act. The power of the FSA here is broad and includes the authority to exercise its power to change permission if it thinks the regulatory objectives would not be achieved. This provides the FSA with extensive scope to exercise its judgement about authorisation. These powers are similar to the directions that the FSA can make under the 1987 Act, in that they can require an institution to take certain steps or to refrain from pursuing a particular course of action, or impose limitations on the acceptance of deposits, granting of credits or making of investments, or prohibit entry into certain classes of transaction.

Under the new regime, once a Part IV permission is granted, a deposit-taking institution that wishes to change its permission governing regulated activities can voluntarily make a request to the FSA to make that change by adding to, removing from or cancelling the existing permission. In order to exercise this power, the FSA has to consider the effect of the change on the interests of consumers and potential consumers by determining whether or not the new permission would adversely affect those interests. The FSA also has the authority to vary the Part IV permission on its own initiative if, for example, the authorised person fails or is likely to fail to meet the threshold conditions, or it is desirable to vary the permission to protect the interests of consumers and potential consumers. These powers are deemed 'own initiative power' and are a formal recognition of the judgement-based approach in financial regulation particularly to banking.[127] The FSA can impose, vary, or remove requirements relating to acquiring control or assisting an overseas regulator, and it can change the asset-requirements of authorised persons.[128] For example, the FSA can vary or impose requirements on an authorised person if there is a change of control, the consequences of which are uncertain. However, the FSMA 2000 does not define what the 'uncertain' circumstances are, nor does it indicate in whose interest the power can be exercised.

[126] Ibid., s. 41
[127] Ibid., s. 45
[128] Ibid., s. 45-48

The FSA's enforcement powers have amalgamated the traditional enforcement powers and sanctions of the Bank with the formal inclusion of fines and opportunity for publicity, so that it now has an enormous enforcement arsenal at its disposal that it did not have before. Sanctions such as publicity and fines mean that the FSA could improve the legitimacy of the compliance-based approach in banking supervision (in particular prudential regulation).[129] This means the FSA can respond to commercial realities by enhancing market discipline without restricting or revoking authorisation. The 'unique' function of banks within the economy means market confidence requires serious consideration so that, while the FSA has devised a single-enforcement policy, it must surely consider the idiosyncratic features of the regulated firms.

The FSA provides a broad criteria to determine whether to take disciplinary action such as financial penalties and/or publicity.[130] They include: whether the malpractice/breach of rules which have taken place are severe in terms of loss or benefit gained and impact on the financial market as a whole; whether there is recklessness in the breach; the timeliness in which the institution notified (if in fact it did) the misconduct. It would also take into account the co-operation the firm provided to the regulator with its investigation.[131] The FSA provides that factors such as previous conduct and consistency with previous cases will require consideration.[132]

### 5.14.1 Publicity

A new sanction against non-compliance is the formal introduction of publicity of misconduct in the marketplace through 'public censure' or 'public statement'.[133] The justification for such a power is to promote the FSA's accountability for the performance of its functions in enforcing the regulatory regime. Publicity of such actions provides a further mechanism in order to secure compliance and, in many respects, fills the middle-ground in banking supervision. Publicity of non-compliance can act as a deterrent mechanism because of the damage it can cause to the reputation of institutions – damage that they would wish to avoid. More importantly, it shows

[129] The consolidation of a single enforcement approach and collection of sanctions including fines and publicity which is contrary to the findings and recommendations of the Arthur Andersen Report (1996) op. cit., n. 54, at p. 20, para., 106
[130] FSA, ENF Chapter 11
[131] Ibid., s. 11.4.1(1) – (2)
[132] Ibid., s. 11.4.1.(3) & (5) respectively; see also FSA, CP 65, (2000) op. cit., n. 87
[133] FSMA 2000 s. 66 and 205 for guidance see FSA, ENF, Chapter 12

that regulation is enforced, thus satisfying the objective of protecting the consumer.[134] Public censure can be used when disciplinary action is required but the misconduct does not warrant a financial penalty, thus highlighting its deterrent affect. [135]

Notwithstanding the necessity of publicity, the perception of 'swelling' prosecution can provide an environment which is considered harassing and inefficient.[136] This is because enforcement decisions need to consider a number of factors in order to ensure observance of the regulatory order, which usually requires the co-operation of the regulated. A hostile environment could be detrimental to the overall regulatory strategy.[137] According to Hawkins, prosecution is the visible evidence of the agency's commitment to ensuring control of the regulated and indicates to the public that it is doing its job properly. Prosecution also brings regulatory deviance to the public view, modest though this may be. Publicity is suggested to exonerate the agency, by showing that it is a credible enforcement authority and acts in a two-fold way. Firstly, it displays regulatory rule breaking and secondly it dramatises the success and effectiveness of the agency.[138]

### 5.14.2 Fines

The decision to impose fines depends upon the nature of the derogation being similar to the FSA's other enforcement sanctions.[139] Another factor taken into account is the impact of the fine on the institution or person.[140] The FSA will have to determine the right level to pitch civil fines in order to ensure that it is neither too low nor too high because, in the former case, the sanction would have limited impact in order to ensure deterrence or retributive effect, whereas in the latter case, they would be too punitive. Such a sanction would be utilised in only the most extreme forms of regulatory misconduct.

134 FSA, ENF 1.2.1 (2) op. cit., n.
135 FSA, ENF s. 12.2.1& 12.3.3
136 R Baldwin, (1998) op. cit., n. 1, at p. 291-292
137 J Braithwaite, *Crime, Shame and Re-Integration*, Cambridge, Cambridge University Press (1989) at p. 75; S Box, *Power, Corruption and Mystification*, London, Tavistock (1983) at p. 9; and W J Chambliss, *Exploring Criminology*, New York, Macmillan (1988) at p. 54
138 R Baldwin, (1998) op. cit., n. 1, at p. 291
139 FSMA 2000 s. 66 and 206 see for guidance FSA, ENF, Chapter 13 s. 13.3.2-3
140 Ibid., s. 13.3.3(3)

A particular concern of civil fines is the unspecified limit to the level of the fine. The FSA have also adopted a tariff of fines for many routine violations of administrative regulations, such as failure to provide timely prudential returns or other critical reports.[141] The indicative scale is not being adopted across the board. The underlying policy advocates general principles upon which the size of the fine is to be measured rather than a tariff of fines. In many respects, avoiding a tariff system would have been a move away from a rules-based approach, because it would culminate in a checklist approach to assess whether the institution or person is in compliance. The adoption of broad principles allows the FSA to exercise its judgement and measure the seriousness of the offence.

Financial penalties will also be used for breaches of prudential regulations. In the case of breach of prudential regulations, this will be new for deposit-taking institutions. However, further examination suggests this measure may not be as retributive as first thought unless the FSA proposes to follow up the fine and change the target and trigger ratio to a considerable extent. According to the Arthur Andersen Report, changes to these ratios generally occurred when the institutions' current ratios were considerably over target. Furthermore, according to a study by A Lucas, the current compliance-strategy of back-testing internal models leads to an under-reporting of market-risk to supervisors and therefore does not entirely achieve supervisory objectives. Lucas advocates stricter enforcement sanctions in order to ensure that banks implement appropriate internal models.[142] Therefore, unless that policy is changed, the use of fines in this area could be simply 'creative enforcement'. This problem is exacerbated because the underlying standards governing prudential requirements are broad and so introducing financial penalties could raise other problems, such as how to identify the point at which a breach has occurred. The general policy justifying the use of fines will mean that a rules-based approach has been adopted, which will be alien to the deposit-taking institutions, since it was the preserve of investment business.

[141] Ibid., 13.5

[142] A Lucas, 'Evaluating the Basle Guidelines for Backtesting Banks' Internal Risk Management Models', Vol. 33, No. 3, *Journal of Money, Credit and Banking*, (2001) 826-846

## 5.15 Conclusion

This Chapter has attempted to analyse the enforcement methods and sanctions practised by the Bank and the FSA under the 1987 Act and FSMA 2000. Central to this analysis were the reasons behind the particular enforcement-methods and sanctions. The evidence suggests that moral suasion/persuasion rather than punishment has been the order of the day. While this policy is legitimated by the Bank and now the FSA, it is encouraged also by studies of enforcement. The policy of compliance is to encourage greater co-operation and trust rather than punishment and retribution. What is clear from the evolution of the enforcement-style of the Bank of England and that adopted by other regulators is that suasion is a central factor in trying to ensure compliance. Clear lessons learnt from past experience are that it is important to ensure that enforcement is 'seen to be done', and that there is consistency in enforcement actions. The FSA has attempted to achieve the latter objective by establishing the RDC. Moreover, with the establishment of the Practitioners' Panel and Consumer Panel, appropriate feedback from interested parties could possibly mean that the risk of regulatory capture is diminished. Finally, it is important to note, as Gower once stated, that 'it is not much use having regulations unless they are enforced'. [143] This is not so far from the truth and in many respects could be a measure to examine future enforcement-actions undertaken by the FSA to assess whether it has actually moved to a more pro-active enforcement strategy. As well as the reasons identified in the main body of the paper, the compliance-based approach identifies the limits of regulation and supervision. Consequently, a pragmatic enforcement method is required, one that does not rely on one particular strategy but rather on a mixed approach, referred to by Scholz as 'Tit for Tat'. The underlying nature of this policy is also supported by Braithwaite in his 'Taxonomy of Enforcement'.[144] According to Braithwaite, a regulatory body is a Benign Big Gun when it can ensure compliance by speaking softly while carrying 'big sticks'. The main characteristic of the Benign Big Gun is that it uses persuasion rather than punishment, even though it carries an arsenal of enforcement-sanctions, including lesser sanctions. This paradox is based on the idea that a regulated entity is 'given an offer it cannot refuse'. Interestingly, what culminates from his study is the idea of 'an

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[143] L C B Gower, *Review of Investor Protection - A Discussion Document*, London, HMSO (1982), at para., 3.14

[144] I Ayres & J Braithwaite, (1992) op. cit., at p. 325-350

optimum way of playing a dynamic enforcement game' rather than an optimum level of 'stringency or enforcement'; neither of these concepts takes a holistic picture of the enforcement environment, but focus on a single aspect of ensuring compliance. It is premature to call the FSA a 'Benign Big Gun'. Furthermore, it might be to harsh to label the Bank as a 'Benign Big Gun'.

Central banks is just one example that Braithwaite gave of a 'Benign Big Gun', it being an authority with a range of powers that it hardly ever uses.[145] In the case of banking supervision, it is clear that the vulnerability of banks has played a significant part in the design of the enforcement style of compliance. However, with the growth of bank-financial conglomerates, this has meant institutions have come to experience a plurality of enforcement styles. Furthermore, the evidence from the US and the enforcement-style adopted there suggests that such a policy is open to criticism. A particular concern of a single regulatory authority is not the single regulatory authority itself but rather, the single enforcement policy. This is because the regulated firms have developed within distinct regulatory cultures and therefore having a single enforcement policy could threaten the salient features of such institutions. To safeguard against this, the RDC will need to examine the objectives of the FSA to ensure that enforcement decisions do not, at the expense of consumer protection, undermine market confidence and result in contagion or systemic consequences. Therefore, the objectives and principles provide an effective context to determine whether a regulatory/enforcement decision complies with the purpose of the FSMA 2000.

Crucial to the success of an enforcement style is a wide range of enforcement sanctions that are not only retributive but also non-punitive. The move from traditional style of enforcement and sanctions to a range of enforcement sanctions does seem to be in line with the re-thinking of regulatory enforcement in the US. The Bank, armed with the ultimate punitive regulatory sanctions, had little in the way of middle-ground sanctions to enforce its regulatory regime. The FSA proposals change the traditional sanctions' base in banking regulation and supervision. This broadening of the sanctions-base addresses the concerns expressed by Arthur Andersen, particularly about a situation when the option is either criminal or punitive civil sanctions that could ultimately lead to the closure of an authorised institution. The feasibility of civil fines (as used by the Federal Reserve Bank of the US under the FIRREA Act 1991) to ensure compliance, especially in the area of supervision, is encouraging. Using publicity as a method of enhancing market-discipline to aid observance and ensure that the stigma attached to regulatory failures acts as an enforcement mechanism in its own right, is a positive move. The formal adoption of a broad range of sanctions that are not necessarily punitive, nor are they the 'nuclear option', means that enforcement officials will not simply have the formal choice between no action and closure. This situation can often lead to legitimate criticism, not only from the regulated about harsh sanctions but also from depositors when no action is taken by the regulator. Such was the case with the Bank.

Banks will experience fines as an enforcement measure (for breaches of administrative and prudential rules) and publicity when compliance is not forthcoming. The policy of using publicity as an enforcement actions will be an important step towards enabling the market-response to act as a deterrent of non-compliance. Whether it will be used to enforce the principles of authorisation remains to be seen. The impact of disclosing enforcement-actions will allow the market to respond to such information. US research on this issue suggests that releasing such information does not necessarily have systemic implications. The conclusions from these studies suggest that this type of information provides the market with material to make realistic assessments of bank risks, so that investors can recognise those banks that are viable and those that are not. It also suggests that such information led to a diminution of the likelihood of contagion.[146] This will require the FSA to take bold steps in banking- supervision so that the market itself can be used as a mechanism to ensure compliance.

[145] J Braithwaite, 'Convergence in Models of Regulatory Strategy', in J Braithwaite, *Regulation, Crime, Freedom*, Dartmouth, Ashgate (2000) at p.104

[146] G Hance, 'The Banking Crisis of the 1980's and Early 1990s: Summary and Implications', at p. 47 in FDIC, *An Examination of the Banking Crises of the 1980s and Early 1990s*, op. cit., http://www.fdic.gov/bank/historical/vol 1.html

# Chapter 6

# The Role of Auditors and Reporting Accountants

## 6.1 Introduction

The external auditor can get a unique insight into an authorised firm, and thus assist the regulator in displaying overall accountability of that firm's business activities.[1] This has led to its popularity both in the UK and internationally. However, regulators have included the external auditor in the supervisory process without implementing measures to ensure their independence, thereby undermining their contribution to the supervision of authorised firms. Furthermore, while the detection of fraud is placed on the shoulders of management,[2] no external regulator or external auditor has the responsibility either *per se* or in principle for searching for fraud or other serious malpractice. This therefore limits the usefulness of external-regulator roles. It is suggested that because the external auditor provides only limited assistance to a regulator, its role should either be curtailed and replaced by greater on-site regulation or by constructive internal mechanisms.

To study the role of accountants in the context of banking supervision it will be important to understand the legitimacy of the profession. An attempt is made to analyse the auditor's role from a regulatory perspective and to determine the contribution auditors can make to the regulation and supervision of authorised institutions. There is a review of literature analysing the standards recommended for auditing regulated institutions by the Accounting Practices Board (APB) and the all-important guidance notes, professional rules and ethics that govern the auditing profession. The following central themes are analysed: 'judgement', 'reasonable assurance', 'material misstatement', 'professional scepticism', and the objective of identifying 'fraud and errors' in financial statements, 'independence' and 'conflict of interests'. Section 1 of this Chapter outlines the way the accountancy profession is regulated and suggests that shortcomings of 'self-regulation' that eventually manifest as 'capture' have entered the relationship of auditor and client. Section 2 focuses on

[1] Chapter 4 Enforcement Method and Sanctions in Banking Regulation and Supervision at p. 161
[2] Chapter 3 Corporate Governance and Banking Supervision at p. 110

how this has made its way into what is required of an auditor in this annual ritual, now perpetuated by the courts' construction of the meaning of duty owed by auditors to shareholders and third parties. Section 3 examines how the auditing profession has, with the legitimisation of the courts steered their role away from 'detection of fraud' to exercising 'professional scepticism'. This is notwithstanding the concerns of qualifying bank accounts and is considered in Section 4. Section 5 considers the duty on auditors to disclose issues of material significance to regulators. However, the wider literature suggests that auditor independence remains in doubt. This concern permeates into the external auditors' role of reporting accountant, when this and other non-audit services provide such a large proportion of the profession's income. In Section 6, inferences are drawn from the decision in *KPMG v The Law Society*, it is suggested that a duty of care should be incumbent upon bank reporting-accountants, as they are on Law Society reporting-accountants. The evidence of the BCCI closure in terms of auditor independence is also considered. Section 7 reviews the alternative mechanisms that are advocated to ensure auditor independence. It is shown that the concerns that filter into their role of enhancing corporate governance exist in this area as well. The strands from the above lead to general conclusions including: external audit-reports provide limited assistance to a regulator and should be filled by either greater on-site regulation or 'constructive' internal mechanisms to avoid regulatory gap such as gateways for communicating regulatory matters internally.

## 6.2 The Audit Profession

The auditing profession has acquired a unique status in the world of commerce, as the auditor of financial accounts. A set of factors led to the rise of the profession: the growth of financial markets that necessitated supervision of their integrity, and the efforts of the profession itself to create its own unique 'professional jurisdiction' for monopolising the audit function.[3] This monopoly has raised a number of concerns, in particular, the effectiveness of the audit and whether the profession is appropriately accountable. The problems raised have traditionally centred round the negative connotations that permeate self-regulation, such as regulatory capture, and

[3] J Maltby, 'A sort of guide, philosopher and friend: the rise of the professional auditor in Britain', 9:1 *Accounting Business & Financial History*, (1999), 29-50 at p. 33

the perception of lack of empathy for the public interest.[4] These labels can undermine the trust relationship between the various interested parties, such as management, shareholder and regulator. It is reasonable to assert that the regulatory problem of capture in the auditing profession also reaches into the actual role of the auditor, and raises the problems of independence and conflict of interests in audit and non-audit activities (management advisory services).[5]

The accountancy profession consists of six professional bodies, the key one being the Institute of Chartered Accountants of England and Wales (ICAEW). The Auditing Practices Board (APB) is the body[6] that develops standards for the auditing profession.[7] The Statements of Auditing Standards provide the basic principles and procedures that govern audits. Practice Notes and Bulletins exert further persuasive influence on the function of audits. The audit is monitored by a number of standards-and-guidance notes meant for enabling the auditor to endorse financial statements produced by management with an opinion on whether its accounts give a 'true and fair view'. The standards and practice statements assist the auditor in interpreting specific principles and procedures.[8] The guidelines aid understanding of what the auditor should and should not do. However, the audit guidelines are couched in an informal and general fashion and present difficulties in terms of their effectiveness.[9]

This does not necessarily mean that wide discretionary rules cannot be enforced. On the contrary and paradoxically, enforcement is carried out by those who devised the rules and developed what is expected: In high-profile cases it is the

[4] A Puxty, P Sikka and H Willmott, 'Mediating Interests: The Accountancy Bodies' Responses to the McFarlane Report' Vol. 27, No. 4, *Accounting and Business Research*, (1997), 323-340 at p. 339

[5] V Beattie, R Brandt and S Fearnley 'Audit regulation: A partial solution expanded' Vol 7 No.1 *Journal of Financial Regulation & Compliance*, (1999) 31-47; P Moizer, 'Review of the Recognised Supervisory Bodies: A Report to the Department of Trade and Industry on the Audit Monitoring Process', Mimeograph; S. Fearnely and M Page, 'Audit Regulation in the UK: Some Preliminary Observations' Vol. 2, No. 2 *Journal of Financial Regulation and Compliance*, (1994) 125-132; S Fearnely, et al, 'Problems and politics of regulatory fragmentation: The case of the Financial Reporting Review Panel and the Institute of Chartered Accountants in England and Wales', Vol. 8 No. 1 *Journal of Financial Regulation and Compliance*, (2000), 16-35

[6] The independence of the APB has come under fire, see: 'Independence defended', February, *Accountancy*, (1995)

[7] Auditing and Reporting 2000/2001: the full text of all UK auditing Standards and Guidelines, all auditing Exposure Drafts and other statements on auditing extant at 30 April 2001

[8] The legal status of these pronouncements, especially the Auditing Standards, are "likely to be taken into account when the adequacy of the work of auditors is being considered in a court of law or in other contested situations" at p. 7, para., 13

responsibility of the Joint Disciplinary Scheme (JDS). The JDS is administered by the Executive Committee, and is constituted of representatives of the professional bodies governing the accountancy profession.[10] The objective of the JDS is to 'promote the highest possible standards of professional and business conduct, efficiency and competence'.[11] Allegations of public concern are dealt with by the Executive Committee.[12]

The JDS essentially deals with high-profile cases and consists of a number of independent parties to ensure its autonomy. An order from it is based on its assessment of the conduct of the parties and of particular audit failings. In instances of making orders, the JDS demands a high professional standards and judgement from its members. Its use of independent parties can be seen as an attempt to meet public expectations of the role of auditor, and thereby, to reduce suspicion of 'capture'. In publishing its Annual Report, the JDS provides both transparency of its work and puts miscreants up for public censure by 'naming and shaming' them. This in its own right can act as a deterrent of non-compliance.[13]

### 6.2.1 FSA: Oversight of the Accountancy Profession?

Concerns about the regulation and supervision of the auditing industry are to do with whether the professions, through the various mechanisms outlined above, can

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[9] J Davison, 'Accountancy's Golden Goose', May, *Management Today*, (1981), 60-65

[10] The Accountants', Joint Disciplinary Scheme (JDS)

[11] Ibid., para., 4

[12] The Executive Committee receives reports from an investigation committee. This is then referred to an Executive Counsel (when a report gives rise to public concerns.) On the request of the Executive Counsel the Executive Committee appoint a Joint Disciplinary Tribunal (JDT). The Executive Counsel acts as the complainant and brings evidence against the individual or firm (members) before the JDT. The JDT has the power to reprimand or severely reprimand a member or member firm and/or fine the party. They take into account the conduct and quality of work reasonably expected of a Member or Member firm in good standing and:

(a) "the duties and responsibilities of that Member or Member firm in relation to the matter under enquiry;
(b) the importance of the work in relation to which the matter has arisen in terms of the magnitude of the sums involved;
(c) the known or potential consequences of any shortcoming revealed by the enquiry;
(d) the need for high standards of professional work to be considered in the light of the reasonable exercise of professional judgement;
(e) the differing responsibilities of Members who are and who are not in public practice having regard in particular to the duties owed by the latter to any organisation in which they work; and
(f) the professional and technical standards which were expected at the time of the conduct in question." Ibid., at para., 8

[13] See Chapter 5 Enforcement Methods and Sanctions in Banking Regulation and Supervision at p. 199

effectively regulate its own affairs. In the US the Securities and Exchange Commission (SEC), the regulator of securities business, has a broad range of powers that stem from its responsibility for providing oversight of financial disclosure and the audit of financial statements.[14] The SEC plays an influential role over the accountancy professions with the guidelines and standards it publishes, and has been a key player in ensuring auditor independence. For example, in 2000 the SEC published a report investigating huge conflicts of interest at Price Waterhouse Coopers, and thus called into question the independence of its activities.[15]

The US approach, with SEC oversight of the professional bodies, has meant that a public body has significant input into the overall regulation of individuals and firms. It is reasonable to suggest that the FSA, with its responsibilities for the authorisation of approved persons, investment exchanges and clearing houses, for the supervision and enforcement of regulated activities[16] and the for listing rules for the London Stock Exchange,[17] is the appropriate body to exercise oversight of the accountancy profession. The FSA, as shown earlier, has a number of objectives: market confidence, consumer awareness, consumer protection and the reduction of financial crime,[18] and can be expected to bridge the expectations-gap between the public and the accountancy profession.

### 6.3 General Purpose

The financial audit is an integral part of corporate governance[19] that makes management accountable to shareholders for its stewardship of a company. It is re-affirmed that this assurance should be provided independently.[20] It is the board of directors' responsibility to prepare the financial accounts and to ensure general compliance with the Companies Act 1985. According to Leggatt LJ:

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[14] GAO Report to the Ranking Minority Member, Committee on Commerce, House of Representatives, *The Accounting Profession, Major Issues: Progress and Concerns*, , Washington DC, General Accounting Office (1996) GAO/AIMD-96-98 at p. 26-28
[15] Report of the Internal Investigation of Independence Issues at PriceWaterHouseCoopers LLP: In the Matter of PriceWaterHouseCoopers LLP U.S. Securities and Exchange Commission AP File No. 3-9809 January 6th (2000)
[16] FSMA 2000 Part VI
[17] Ibid., Part XVIII
[18] Ibid., Part I s. 2 (2)
[19] M Power, *The Audit Society: Rituals of Verification*, Oxford, Oxford University Press (1999)

*"The primary responsibility for safeguarding a company's assets and preventing errors rests with the directors...An auditor's task is so to conduct the audit that material misstatements in the financial documents will be detected."*[21]

His Lordship's explanation places the role of the auditor clearly in its professional context, based on the reporting responsibility of the directors. This definition was supported in the decision by Leggatt J, for whom a broader interpretation would have meant 'a radical extension of the liabilities shouldered by an auditor', that would culminate in insurer-against-company losses.[22]

There are a number of questions about the purpose of the external-auditor role since its traditional role has been extended into the arena of the regulated industry. This wider commercial and regulatory responsibility transcends foreign jurisdictions where the integrity of the participants is not confined to a single isolated jurisdiction. Therefore, the opinions of the external auditor are the basis for commercial and regulatory decisions on a global consolidated basis[23]. However, external auditors have attempted to place obstacles in the way of regulators investigating failures with claims that they are acting independently in another jurisdictions, even though they are part of a global organisation. This raises the issues of user expectations about responsibility to shareholders and depositors and assurance (to the financial markets and the regulator) of the integrity of financial information that an institution provides. These expectations of the external audit are made even more burdensome when the audit is not the only service provided to an audit client. In providing non-audit services (e.g. consultancy services) there is the possibility of the external auditors exceeding thc limits of their authority. The legal status of external auditors still remains imprecise, thus the concern about whether they can act in the public interest in a quasi-regulatory role. According to Hanlon, the central concern of an audit has always been the needs of the customer and not the wider public interest.[24]

[20] A Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*, Gee Publishing London (1992) (Cadbury Report); R Hampel, *Committee on Corporate Governance: Final Report,* Gee Publishing London (1998) (Hampel Report)
[21] *Barings plc v Coopers & Lybrand* [1997] 1 BCLC 427 at p. 435
[22] *Bank of Credit and Commerce International (Overseas) Ltd (in liquidation) and Others v. Price Waterhouse and Another (No. 3)* The Times, Thursday April 2nd 1998
[23] *Barings plc v. Coopers & Lybrand*, High Court of Justice, Chancery Division, August 2, 1996 The Independent, October 1, 1996. J Gray, 'Barings plc v. Coopers & Lybrand: Auditor of subsidiary can owe duty of care to parent', Vol. 18 No. 2, *The Company Lawyer* (1997) 57-58
[24] D Hanlon, *The Commercialisation of Accountancy*, London, St Martin's Press (1994)

Nevertheless, society is still concerned about the role of the auditor in detecting fraud.[25] It finds it inconceivable that an external auditor, in the course of carrying out an audit, can fail to notice irregularities of a criminal nature in the maintenance of an institution's accounts.

The expectation-gap increases whenever companies publicise losses or collapse due to fraudulent activities that should have come to light during the audit of the financial statements.[26] The role of auditor is somewhat difficult to define in terms of the social expectations on them.[27] The expectations-gap between auditor duties and auditor performance is a persistent problem not only in the UK but also internationally.[28] The expectations of the public are often at variance with the legal and professional duties of auditors. The notion 'expectations-gap' was first brought to the public platform in 1978 by the US Cohen Commission,[29] and is generally interpreted as the gap between the public perception of the role of the auditor and the professional duties and standards incumbent upon auditors in the performance of their duties. Pressure, fuelled by the expectations gap has been considerable, even though the audit profession has pointed out that it arises from a misinterpretation of the auditor role. It is encouraging public education about the nature of that role in order to correct the public's unrealistic expectations of it.[30] Nevertheless, it would be wrong to say that the gap has not led to a change in the ways that the profession is regulated and in the ways its general purpose is understood.

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[25] The Auditing Practices Board, *Fraud and Audit: Choices for Society*, Consultation Paper, November (1998) at p. 10, para., 1.19

[26] R D Miller, 'Government Oversight of the Role of Auditors', September, *The CPA Journal*, (1986), 20-36

[27] P Sikka, 'The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence' Vol. 9 *Critical Perspectives on Accounting*, (1998), 299-330

[28] A Cadbury, (1992); Hampel Report, (1998); D Tweedie, *Challenges Facing the Auditor: Professional Fouls and the Expectation* Gap, The Deloitte, Haskins and Sells Lecture, University of Cardiff, 30 April 1987. H C Willmott, 'Organising the Profession; A Theoretical and Historical Examination of the Major Accounting Bodies in the UK', Vol. 11, *Accounting, Organisations and Society*, (1986), 555-82. F Milne and R Weber, 'Regulation and the Auditing Profession in the USA: The Metcalf Subcommittee's Recommendations Re-examined', Summer, *Accounting and Business Research*, (1981), 197-205. J W Hill, 'The Spectre of Disproportionate Auditor Liability in the Savings and Loans Crisis', 5 *Critical Perspectives on Accounting*, (1994), 133-177. See Compendium of Documents produced by the Basle Committee on Banking Supervision. Volume Three, *International Supervisory Issues*. Basle April 1997 Chapter III. 'The Relationship between Bank Supervisors and External Auditors' (A joint paper issued as an International Statement on Auditing by the International Auditing Practices Committee) July Basle (1989), 74-89

[29] American Institute of Certified Public Accountants (AICPA), 'Report Conclusions and Recommendations of the Commission on Auditor's Responsibilities', re - printed April, *The Journal of Accountancy*, (1978), 92-102

A number of issues have remained on the expectations agenda, particularly about the detection of fraud.[31] The question of detecting fraud has not diminished to this day, even though the idea of an audit has developed over time and with the changes in society.[32] The primary objective of the audit in today's society is the verification of financial statements. Accounting literature and the architects of accountancy show that the traditional role of the audit was primarily the detection and prevention of fraud.[33] Ironically, the move to verification of financial accounts emanated from the growing investment in the railway, insurance and banking industry. It is suggested that this situation arose because in these particular industries the shareholding was more dispersed and more importance was placed on financial performance and return on investments rather than on the honesty of management.[34] Interestingly, the failure of particular banks, such as Johnson Matthey and BCCI, contributed to re-thinking the objective of an audit to include the detection and prevention of fraud. It is important to note the verification of financial accounts and detection and prevention of fraud have never really been viewed as a mutually exclusive objective. Their importance has been concentrated on particular periods of time.

However, whilst the auditing profession made every effort to re-enforce the responsibilities of the auditor, they have been determined to place as much distance as possible between their duty and the prevention and detection of fraud. According to Willinham, the profession itself removed the objective to detect and prevent fraud instead of changing its social purpose[35] in response to the growing concern about the detection of fraud and the growing reluctance of the profession, because of the cost implications, to extend its duties in this area. The Auditing Practices Committee (APC) published revised guidance on fraud and error in 1995.[36] Whilst the guidance sheds some light on the matter it still limits the responsibilities of auditors in relation

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[30] R Buckley, *What is an Audit? Audit Brief*, London Accounting Practice Committee (1980).
[31] C Humphrey, 'The Audit Expectations Gap- Plus Ca Change, Plus C'est la meme chose?' Vol. 3, *Critical Perspectives on Accounting* (1992), 137-161
[32] APB, (1998) op. cit., n. 25
[33] L Dicksee, *Auditing: A Practical Manual for Auditors*, London Gee (1892); see also: R G Brown, 'Changing Audit Objectives and Techniques', April, *Accounting Review*, (1975), 285-297
[34] R A Chandler, 'Changing Perceptions of the Role of the Company Auditor, 1840-1940', Vol. 23, No. 92, *Accounting and Business Research*, (1995), 443-459 at p. 444
[35] J J Willinham, 'Discussant's Response to Relationship of Auditing Standards to Detection of Fraud', April *The CPA Journal*, (1975), 18-21

to the detection of fraud, persistently placing the ultimate responsibility for its detection and prevention on the board of directors and management. Nevertheless, the auditor is required to undertake the audit with reasonable care to detect material mis-statements.

### 6.4 The Role of Courts and the Standard of Care

A particular issue that continues to widen the expectations-gap and the risk of litigation is the poorly-done audit. The courts have persistently refused to enforce the provisions of the guidelines and hold auditors liable for their violation, even in the regulated sector when the auditor is to fulfil broader objectives and additional duties.[37] This makes it impossible to establish a duty-of-care to safeguard the interests of particular third parties, such as investors or depositors. This principle stems from the House of Lord's decision in *Caparo v Dickman*,[38] which re-enforced the privity of the audit contract even when the contract is for the benefit of a third party. Consequently, their Lordships decided that auditors owe a duty of care to the company shareholders as a whole, rather than to any individual shareholder, because shareholders collectively monitor management's stewardship of a company. However, this is notwithstanding the fact that the auditor has to undertake his work with reasonable care and can involuntarily incur liability *vis-à-vis* a third party.[39]

While the auditor could be deemed responsible for the failure to draw to the attention of the directors material misstatements, it would be unjust to suggest that sole responsibility lies with the auditor. In these circumstances it is legitimate to rationalise causation, consequently distributing the degree of blameworthiness between the parties on the basis of contributory negligence.[40] Although the detrimental reliance of regulators and directors on their opinions and reports could be

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[36] APB, *Statements of Auditing Standards Fraud and Error,* January, APB, 1995

[37] S Chua, 'The Auditor's Liability in Negligence in Respect of the Audit Report', *Journal of Business Law,* (1995) 1-20; C J Napier, 'Intersections of Law and Accountancy: Unlimited Auditor Liability in the United Kingdom', Vol. 23, No. 1, *Accounting, Organisations & Society* (1998) 105-128

[38] *Caparo Industries plc v Dickman and others* [1990] 1All ER 568 This case related to a take-over, where the audited accounts, misstated the profits of the targeted company Fidelity.

[39] *Candler v Crane Christmas & Co* [1951] 2 KB 164; *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 The latter case adopted Lord Denning's dissenting opinion in *Candler* relating to doctrine of privity at p. 535

[40] *Daniels v Anderson CA. (NSW)* 16 ACSR (1995) 607

deemed a contributing factor, it is not necessarily the sole factor. In many cases, for the auditor to be fully liable for the failure of a company would be unfair.

The issue of fault and contributory negligence arose in *Daniels v. Anderson.*[41] The audit of AWA by Daniels came under particular scrutiny because it failed to address concerns which arose in the audit process. These were issues that should have been communicated to management and ultimately to the board of directors. The auditor had a clear duty to communicate to the company the serious limitations in the company's record-keeping and internal controls.[42] The findings and judgement of Rogers J were re-asserted by the Court of Appeal, where it was decided that the continuing negligence of the auditors 'exacerbated' the whole matter because they failed to comply with s.285(4) of the Companies (New South Wales) Code. Moreover, the auditors should have formed the clear opinion that AWA did not have proper accounting records. Whilst the auditors in the case were negligent in their duty to the company and the shareholders, it was right that the auditors were not to carry be all the blame. The management of the company had not exercised effective supervision, of the individual who made the foreign-exchange transactions.

The audit standards and guidelines are mere guidelines for an auditor, therefore it is possible for two sets of auditors to interpret the same standards in a number of ways leading to different interpretations. This has been affirmed by a number of decisions such as in *Lloyd Cheyham & Co Ltd v Littlejon & Co*,[43] and more recently, by the decision in *Esanda v Peat Marwick Hungerfords.*[44] According to the decision in the latter case, relating to the Australian Accounting Standard AAS5, an auditor is required to consider the needs of 'prime users'. However, according to McHugh J, reference to AAS5 was not a public undertaking of legal responsibility by members of the Institute, nor did it create a duty of care. What it did provide was guidance to determine the standard of care expected once a duty of care was established.[45] The standards highlighted were merely guides to interpretation

[41] *Daniels & Ors v AWA Ltd* (1995) 13 ACLC 614
[42] Ibid., at p. 647
[43] *Lloyd Cheyham & Co Ltd v Littlejon & Co* [1987] BCLC 303
[44] *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 71 ALJR 448
[45] Ibid., at p. 475

providing little basis for establishing duty, hence remaining a tool for interpretation rather than becoming an instrument for determining legal responsibility.[46]

For McHugh J, the traditional concerns of imposing liability on auditors are not only prevalent in the UK but also in Commonwealth case law and in the US.[47] This is because auditors exercise a professional judgement which could increase their exposure to liability. It could also increase the costs of auditing, which would ultimately be borne by the client and thus reduce competition among service providers and diminish standards in the provision of the service. The increased likelihood of liability does not necessarily act as a deterrent of non-compliance with auditing guidelines. According to the decision in *Hill,* increasing the legal risk does not necessarily serve the objective of tort law, such as deterrence, because tort law's objective of deterring socially undesirable behaviour will not be served by disproportionately expanding auditors' liability.[48] Whilst the consequences of making auditors liable for their failures in assessing the quality of financial statements prepared by management is a major issue, case law in this area holds that auditors are not insurers against the failure or losses of a company. The contribution of an auditor to the demise of an authorised institution or company is not necessarily the sole cause of the loss or collapse, although the reliance of regulators and directors on their opinions and reports could be deemed a contributing factor. Therefore, in many cases for the auditor to bear the whole liability for such failures would be inequitable.

### 6.4.1 Detection of Fraud

The role of the auditor in the detection of fraud as defined by the courts has changed little in terms of expectations. This general conclusion is a culmination from a number of decisions such as in *Re London & General Bank*[49] and *Re Kingston*

[46] Ibid., McHugh J at p. 475 referred to *Columbia Coffee & Tea Pty Ltd v Churchill* (1992) 29 NSWLR 141

[47] Ibid., at p. 471

[48] J W Hill, 'The Spectre of Disproportionate Auditor Liability in the Savings and Loans Crisis', *Critical Perspectives on Accounting*, Vol. 5, (1994) 133-177 at p. 155-159

[49] *Re London & General Bank* [1895] 2 Ch 673. According to *Lindley LJ* at p. 683:

"An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer, he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say by fraudulent concealment of a book from him. His obligation is not so onerous as this."

*Cotton Mill Co*[50]. The decisions suggest that the auditor is to exercise reasonable care and skill in order to certify what is believed to be true. However, the auditor should also assess the level of suspicion or enquiry needed depending on the circumstances of each case. According to Lopes LJ:

> *"He is a watch-dog, but not a bloodhound...If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."*[51]

Whilst the reasoning of Lopes LJ has lasted the test of time, caution was sounded by Lindley LJ, who was concerned that the reasoning could lead to serious error. Whilst in *Re Kingston Cotton Mill* Vaughan Williams J said that there is "[n]o doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them,"[52] the limitations of the auditor's responsibilities have been further elaborated upon in *Caparo* and remains the benchmark for assessing standard-of-care. According to Lord Oliver of Aylmerton:

> *"It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from consequences of undetected errors or, possibly, wrong doing...and second, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."*[53]

As the earlier cases established, the auditor is required to exercise reasonable skill and care while ensuring an adequate level of enquiry, appropriate in the light of the circumstances, with a limited duty to detect wrongdoing or fraud. Consequently, the standard of knowledge, skill and care required would be that expected of a reasonably competent auditor.

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[50] *Re Kingston Cotton Mill Co* [1896] 2 Ch 279. This case related to an audits overstatement of stock in trade.

[51] Ibid., [1896] at p. 288-289

[52] In the earlier decision, *Re Kingston Cotton Mill Co* [1896] 1 Ch 6 at p. 11

[53] *Caparo* [1990] op. cit., n. 38 at p. 583

### 6.5 The Audit of Bank Financial Statements

Auditing of accounts has been a crucial process to ensure the integrity of the financial statements of companies. This is nowhere more so than in banking institutions. The Banking Act 1987 formally introduced the role of the external auditor in the supervision of authorised institutions after the Johnson Matthey affair,[54] from which point the role of the auditor grew, rather than contracted, in terms of its involvement in banking supervision. This continues to be the case with the introduction of the FSA and the FSMA 2000.[55] Under s.340-346 of the FSMA 2000 the auditor is retained as an integral part of the regulation and supervision of authorised persons. Section 344 of the FSMA 2000 puts the responsibility for the removal, resignation or re-appointment of an auditor on the authorised person, and it is the responsibility of the authorised person to notify the Authority of such actions.[56] The FSA inherits a large proportion of powers from the previous regulatory regimes, in particular to the s.341-342 rules about information sharing and the duty to notify the FSA of matters arising from auditors' work.[57]

The compulsory audit of bank financial-statements was first introduced with the Companies Act 1879,[58] emanating from a fraud at the City of Glasgow Bank and other bank failures at that time. The essential failure was the fact that none of the banks had arranged a thorough audit of their accounts. Whilst it was recognised at the time that the audit was not a panacea for preventing all bank failures, according to Lord Cross, placing a duty on auditors to state a bank's actual position would be a task which 'no human could perform'.[59] Notwithstanding the limits of the audit, it was clear that the audit could have pre-empted the problems and prevented the losses that occurred, as Lord Denman explained:

> *"Many of your Lordships will remember that in 1855 the question of an independent audit was considered, and in my opinion, if there had been an*

[54] Bank of England, *The Relationship between the Supervisors, Auditors and Management of Banks*, Consultation Paper by the Bank of England, 20th August, (1985)
[55] FSA, Supervision Manual: Chapter 3, Auditors, para., 3.2.1G
[56] This was governed by s. 46 (1) of the Banking Act 1987
[57] SUP 3: Auditors, op. cit., n. 55 at para., 3.7-3.8
[58] According to P. Sikka in 1836, out of 107 banks, only nine had auditors whilst 14 had power to appoint auditors but chose not to exercise it. With the enactment of the Companies Act 1879, out of 159 banks 128 appointed auditors. P Sikka, at p. 308 who cites particular reference to E Cooper, Chartered 'Accountants as Auditors of Companies', *The Accountant*, 13th November, (1886), at p. 644-649
[59] House of Commons, Session 12th August (1879b) at col. 857

*independent audit of the City of Glasgow Bank accounts, the disaster which is deplored by so many thousands, and which has ruined so many families, would not have occurred.*"[60]

While the audit remained important as a deterrent of fraud, the post-war period saw a change in direction away from the audit function and to greater reliance on disclosure-policies complementary to the audit.[61] According to Bruce-Gardyne:

"*All company legislation (incorporating the audit) should essentially have two objectives. First, it should be designed to encourage the efficient use of capital and to provide the shareholder with information to judge where his capital is most likely to be most efficiently used. Secondly, it should be designed to protect the shareholder from oppression or fraud by management.*"[62]

However, the Jenkins Committee considered that the policy of disclosure should not be applied to banking and insurance institutions[63] because there was always the concern of disclosing an adverse opinion that could threaten its existence. At this time shareholder rights were considered secondary to the wider public interests of stability and ensuring confidence within the banking industry. The policy of non-disclosure was criticised in the Jenkins Committee and reversed in the 70s.[64] This process continued later with the introduction of the Bank Accounts Directive and through the work of Basel. The directive brought the disclosure-requirements of banks in line with member states and companies incorporated under the Companies Act 1985.[65] The policy of disclosure and transparency is a persistent problem and not simply a domestic regulatory concern but an international one, and requires the regulator to balance the interests of the market with those of depositor interests and avoid unwarranted market disruption.[66] The issue of disclosure, in relation to banks, is

[60] House of Lords, Session 14th August, (1879) at col. 967
[61] Jenkins Committee, *Report of the Company Law Committee appointed by the Board of Trade*, (1962), (Cmnd 1749)
[62] House of Commons, Session, 21st February 1966 at col. 115
[63] From Gladstone "Publicity is all that is necessary. Show up the roguery and it is harmless" Hansard LXV [1844] 277; The Cohen Committee (1945), at p. (Cmnd 6659) and Jenkins Committee (1962) at p. 158 respectively examined the issue of auditing bank accounts and came to the conclusion that disclosure and expressing a 'true and fair' view was not in the public interest.
[64] See the Dissenting Opinion, Jenkins Report, at p. 215; Statutory Instruments. No.327. Companies: The Banking Companies (Accounts) Regulations, (1970), 1205
[65] Council Directive of 8th December 1986 on the Annual Accounts and Consolidated Accounts of Banks and other Financial Institutions 86/635/EEC. SI (Bank Accounts) Regulation 2705 (1991)
[66] Basle Committee on Banking Supervision, *Enhancing Bank Transparency, Public Disclosure and Supervisory Information that Promote Safety and Soundness in Banking Systems*, Committee on Banking Supervision, Basle, Sept. (1998). G22 Working Group, *Summary of reports on the*

a very sensitive issue because of the risk of a bank-run and systemic risk in the wider financial markets affecting the real economy.[67]

### 6.5.1 The Objective and General Principles of a Financial Audit

The audit is based on a contractual relationship expressed by a letter of engagement between the auditor and the client in which the client and auditor agree the terms of the engagement.[68] This is undertaken by indicating the responsibility of both the auditor and board of directors within the letter of engagement, in particular, the scope of the audit and the nature of the engagement[69]. The dialogue between the auditor, management and the regulator is central to the verification process the regulatory regime. Weaknesses identified in the audit are subsequently discussed with management and disclosed to the regulator as part of a bilateral or trilateral discussion between the parties. This discussion is essentially part of the process of ensuring that audit weaknesses are pointed out to the regulator and resolved by the management of the bank.

The audit originates from both an express intention between the parties and specific objectives and principles, both statutory and professional. An audit, under the Companies Act 1985 s.235, requires the auditor to verify whether the financial statements give a 'true and fair view' of the financial health of the company[70] and include an opinion under s.237 about whether proper accounting records exist. The standards which underpin professional competence and amounts to due care can be interpreted widely but encompass a general obligation to the end users of the financial statements. The compliance of auditors with the standards of auditing practice and the ethical standards guides their work to enhance the integrity of the audit. Ultimately, it reduces the likelihood of overseeing material misstatements which could have legal

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*International Financial Architecture: Working Group on Transparency and Accountability*, G22 Working Group, October (1998)

[67] See Chapter 2, The Role of the Bank of England and Financial Services Authority at p. 48

[68] Auditing Practices Board, *Statement of Auditing Standards, Engagement Letters SAS 140*, APB, London

[69] FSMA 2000 s. 342, includes an obligation to report to the FSA

[70] The expression 'true and fair' is rather controversial and it is reasonable to assert that simply 'true' is the appropriate word. See generally: P Bird, 'What is "A True and Fair View"'? *Journal of Business Law*, (1984) 480-485; P Bird, 'Group Accounts and the True and Fair View', *Journal of Business Law*, (364-368; K P E Lasok and E Grace, 'The True and Fair View', Vol. 10, No. 1, *The Company Lawyer*, 13-19; A McGee, 'The 'True and Fair View' Debate: A Study in the Legal Regulation of Accounting', Vol. 54, *Modern Law Review*, (1991), 874-888

consequences and/or professional disciplinary actions[71]. In order to undertake the task, the auditor should:

- carry out procedures designed to obtain sufficient appropriate audit evidence in accordance with Auditing Standards contained in SAS's, to determine with reasonable confidence whether the financial statements are free of material misstatement;
- the overall presentation of the financial statements, in order to evaluate and ascertain whether they have been prepared in accordance with the relevant legislation and accounting standards; and
- issue a report containing a clear expression of their opinion on the financial statements (SAS 100.1)[72].

The role of the auditor is, according to the audit guidelines, to provide 'reasonable assurance' that the financial statements reflect a 'true and fair view' of the financial state of the institution. The notion of 'reasonable assurance' is laden with professional discretion and the exercise of 'professional judgement', which is part of the standard of care of a reasonable auditor. This is based on a combination of 'fact and judgement', so the view expressed cannot be considered as 'absolute' or 'correct'. The concern then falls on whether the inaccuracy or 'audit risk' stems from the inherent limitation of the audit or 'material misstatement' made by the client. Insofar as material misstatement is concerned, auditors need to examine the audit evidence making up the financial statements to provide 'reasonable assurance' that the financial statements give a 'true and fair view'. Crucially, the auditor is required to undertake the audit process 'critically' and with 'professional scepticism'.[73]

The idea of 'professional scepticism' underpins the audit, and in the literal sense, suggests an evaluation that does not accept the audit evidence at face value but questions the soundness of the information and data given. Vigilance builds on this by pointing out that the auditor needs to be circumspect and cautious. Scepticism and vigilance are interdependent in terms of ensuring the audit is seen to be independent

[71] The Auditing Practices Board, *Practice Note* 19, *Banks in the United Kingdom*, May, (1999)
[72] APB, Objectives and General Principles Governing an Audit of Financial Statements at p. 13, para., 2
[73] Ibid., at p. 16, para., 11

and objective. According to the APB Consultation Paper [74] the level of scepticism has declined, thus a greater degree of scepticism is required, consisting of more probing and (almost) of suspicion throughout the audit. However, the APB suggests less draconian measures, such as greater education and training, with more emphasis on fraud-detection than on legal duty. Notwithstanding these long-term requirements, the APB recognises the importance of reducing the likelihood of conflicts-of-interest that undermines the level of scepticism an auditor is required to have. This can be overridden by concerns relating to costs of the audit and appearing antagonistic to management when seeking more audit evidence and thus seeming to be inefficient.

The auditor is required to gather sufficient and appropriate audit evidence. This ultimately requires him to trust the source and reliability of the evidence that satisfies the professional judgement of a competent auditor. According to Standard 400, the auditor needs to satisfy both sufficiency (that is, the measure of the quantity of audit evidence) and the appropriate quality and reliability of the evidence[75]. The audit evidence is gathered by various means: inspection, observation, enquiry and confirmation, computation and analytical procedures. Ultimately, the auditor would have to exercise professional judgement as to the potential risk of material misstatement by running tests of the control-systems and carrying out substantive procedures to determine whether the directors' representations are reliable. If the auditors cannot obtain sufficient and appropriate evidence, then they need to consider the impact, if any, on the financial statements. Unless auditors probe sufficiently they will not be able to judge whether a certain set of facts makes a material misstatement of a financial statements. This leaves the auditor in a very vulnerable position, which can only be overcome by incorporating a sufficient element of scepticism into the whole process of gathering audit evidence, which on occasion requires independent verification.

Whether the work falls short of what is expected requires consideration of the level of scepticism exercised by auditors and the degree of diligence and quality of the work performed. This can be shown in the Joint Disciplinary Tribunal Report into

[74] APB, (1998) op. cit., n. 25, at p. 24, para., 3.7
[75] Auditing Practices Board, Statement of Auditing Standards, *Audit Evidence* [400], (Issued March 1995)

the auditing failures relating to the Mirror Group pension fund, regulated by Investment Management Regulatory Organisation (IMRO). The firm, then known as Coopers & Lybrand, and individual partners were fined for their failures to report to IMRO various regulatory breaches by the Maxwell Group[76]. The Tribunal Report highlights a number of failures that undermine the very basis of an audit. The JDT held that there was a severe lack of adherence to IMRO rules and deficient audit-practice in establishing primary audit facts, consideration of third parties, reviews and overviews[77]. Although the Maxwell Affair raised audit concerns between 1988-1991, before auditors had a duty to report certain circumstances to regulators, the failure there still raise concerns about the objectiveness of auditors and their failure to report to the regulator inadequacies identified in an interim audit. (In the Maxwell Affair, such inadequacies were understated in a management letter to IMRO[78].)

### 6.6 Practice Note 19

The question of the auditor's role particularly comes into mind when a serious error or fraud has resulted in losses or the collapse of an institution such as a bank. The issue of whether auditors are responsible for the detection of fraud has produced a glut of literature. There has been a persistent reluctance to make auditors responsible for the detection of fraud, and this has confirmed the profession's view of its limited role. This section analyses the essential features of Practice Note19 in the context of fraud and error.

According to SAS 110, the auditor does not conduct the audit to prevent fraud or error, but rather to act as a deterrent against the likelihood of fraud.[79] The auditor is expected to plan, perform and evaluate audit work in order to have a reasonable expectation of detecting material misstatements that arise from fraud or error in financial statements. The standard inevitably recognises the difficulty of detecting fraud in concealed or falsified records, or in some cases, in a collusion between

[76] Joint Disciplinary Scheme. Joint Disciplinary Tribunal (into 35 complaints against Coopers & Lybrand Deloitte ("The Firm") and 20 complaints against John Steven Cowling (Mr Cowling). Report of the Joint Disciplinary Tribunal, (1998)
[77] Ibid., (1998) at p. 4, para., 11
[78] Joint Disciplinary Tribunal Report, (1998) op. cit., n. 76, at p. 9, para., 24
[79] The role of the auditor in the detection of fraud and error is governed by SAS 110. This states that:

parties. This shows that the audit of financial statements has inherent limitations of detecting fraud. The possibility of fraud requires the auditor to incorporate the detection of fraud into the planning of the audit.[80] Compliance with this requires auditors to be aware of conditions that can increase the likelihood of fraud or error, to carry out a risk-assessment, and to design an audit such that there is reasonable expectation of detecting misstatements arising from fraud or error.

It is held that the audit is not planned around detecting small elements of fraud, presumably because of the cost implications of such exercise.[81] This notwithstanding, SAS 110 requires the auditor to identify the type of person involved and the likelihood of the fraud or error. This may require expert advice in the assessment of the fraud in the financial statements.[82] However, once fraud is suspected, the auditor is required to report it to the appropriate third parties.[83]

A number of factors are noted about the nature of a reasonable expectation of detecting fraud or error'. Practice Note 19 outlines the rudimentary factors that could increase the risk of fraud or error in a banking environment. Those listed here have increased in prominence with the Barings debacle,[84] building on SAS 110's list conditions or events that could increase the likelihood of fraud.[85] Once fraud is

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> "Auditors should plan and perform their audit procedures and evaluate and report the results thereof, recognising that fraud or error may materially affect n. the financial statements." at para., 2

[80] SAS 110.2 states:

> "when planning the audit the auditors should assess the risk that fraud or error may cause the financial statements to contain material misstatements." at para., 24

[81] APB, (1998), op. cit., at p. 17, para., 2.19-2.27

[82] The auditors are required to comply with SAS 520 *Using the work of an expert.*

[83] SAS 110.5:

> "When the auditors become aware of, or suspect that there may be, instances of error or fraudulent conduct, they should document their finding and, subject to any requirement to report them direct to a third party, discuss them with the appropriate level of management." at para., 33

[84] Practice Note 19:

- "Elements of the remuneration package (particularly bonuses) for certain staff who are directly linked to reported profits;
- Inadequate segregation between the front and back offices;
- Backlogs in key reconciliations, particularly those over correspondent bank accounts and assets such as securities." APB, Practice Note 19 (1999) op. cit., n. 76 at p. 18, para., 54

[85] SAS 110:

- previous experience; or
- incidents which call into question the integrity or competence of management, in particular financial reporting pressures within an entity;
- weaknesses in the design and operation of the accounting and internal controls system;

detected, the audit is required to extend procedures to assess, in terms of the meaning of 'materiality' in SAS 220, the extent of that fraud and its potential impact on financial statements.[86] When considering the above factors it is important to consider whether the matter would reasonably influence the client. The question of what is material is subjective, thus dependent upon the auditor's individual professional judgement. Consequently, auditors will require directors to rectify their financial statements if they contain isolated or cumulative misstatements that do not, in the opinion of the auditor, require the accounts to be qualified.

'Scepticism' and 'vigilance' are paramount in an audit. This is particularly so where directors and senior management could reduce the value of audit evidence by collusion or concealment. When scepticism and vigilance are lacking and the audit is based on material misstatements, then it is an inherently defective audit. The conditions mentioned above are not exhaustive; they encompass a number of areas where potential fraud or error can arise, especially in the context of weak internal control systems. In order to identify the weaknesses, an effective understanding of the internal control systems is required. The auditor needs to proceed with an effective audit-plan so that he can exercise professional judgement to determine the impact of the risks an authorised institution is taking.[87] The way a business is undertaken can be assessed on the effectiveness of its internal control systems at achieving desired ends. This is particularly appropriate when large volumes of transactions are processed. When circumstances suggest the possibility of fraud or error, the degree of inquisitiveness and scepticism should increase concomitantly and should express itself by seeking to obtain evidence from independent sources to verify the existing

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- unusual transactions;
- problems in obtaining sufficient appropriate audit evidence; and
- factors unique to an information systems environment which relate to conditions and events described above. APB, *Fraud and Error*, (1995) op. cit., n.84, para., 24

[86] When evaluating the possible effect of dishonest or fraudulent conduct on the financial statements, the auditors consider its potential materiality. This includes an evaluation of:

- the potential financial consequences, such as fines, penalties, damage, threat of expropriation of assets, enforced discontinuance of operations and litigation;
- whether the potential financial consequences require disclosure, and if so, the adequacy of any disclosure;
- whether breaches of laws and regulations may be involved; or
- whether the potential financial consequences are so serious as to call into question the view given by the financial statements. APB, *Fraud and Error*, (1995) op. cit., n. 84, para., 31

[87] Practice Note 19, SAS 300: Accounting and Internal Control systems and Audit Risk Assessment, op. cit., n. 76, at p. 26-30, para, 79-85

evidence. Management representations can provide only limited assurance when the extent of a fraud is being determined.[88]

This was a criticism raised by the JDT in the audit failures surrounding the Maxwell Affair. According to Cowling's own submission, he had accepted an approach to the treatment of loans and related party-transactions without a 'detached eye'.[89] This highlighted the need to be far more sceptical when considering the degree of reliance placed on management representations. This is crucial for any audit, let alone for the audit of an authorised institution, where the FSA needs to know, to assure itself of auditor propriety, about material misstatements and the degree of reliance on the board of directors and management.

While the level of auditors' scepticism and vigilance during the auditing process is an essential consideration in determining whether they had performed their duties with appropriate skill and care, further criteria, such as efficiency and competence, are warranted also. These facets of standard of care came under scrutiny by the JDT in the action against Messrs Spicer and Oppenheim, the auditors of Atlantic Computers plc.[90] The key facts had to do with the way Atlantic leased computers to its clients: the flexibility of the leasing agreements had stark financial consequences. The 'walk agreements' meant that Atlantic Computers plc was exposed to the risk of clients not renewing the leasing agreement, which would have a significant adverse effect on profits for the company. The case invoked a number of the provisions of the Auditing Standards and Guidelines, and allegations of non-compliance were made on the basis of those provisions: Operational Standard 101, Guideline 201 (Planning, Control and Recording), Guideline 203 (Audit Evidence),

[88] SAS '110.4' states:

> "When auditors become aware of information which indicates that fraud or error may exist, they should obtain an understanding of the nature of the event and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements. If the auditor believes that the indicated fraud or error could have a material effect on the financial statements, they should perform appropriate modified or additional procedures." at para., 29

[89] Joint Disciplinary Report (1998) op. cit., n. 76, at p. 9, para., 22

[90] Joint Disciplinary Scheme, Joint Disciplinary Tribunal, before: Sir John Bailey KCB – Chairman, Mr F E Worsley FCA, Mr J C Platt FCA. In re: *Complaint against Messrs Spicer and Oppenheim,* Case No. 04/97

and Guideline 402 (Events after the Balance Sheet Date)[91]. The Tribunal held that the 1988 accounts for Atlantic Computers plc did not show a 'true and fair view' of the actual or potential liabilities. Moreover, no provisions were made for the actual or contingent liabilities in respect of the leasing arrangements. Matters that should have caused concern were not investigated in any significant detail. Consequently, according to the Tribunal, there were serious audit failings. This attracted penalties of censure and a fine of £100,000 in costs for bringing the proceedings.[92] The fines of audit firms are considered ineffective for deterring non-compliance with the standards required to undertake an audit with reasonable care.

### 6.7 Qualification of Bank Accounts

The problem arises in the case of qualifying the accounts, especially in the case of banks.[93] The issue of qualification has been made even more contentious with the introduction of going-concern statements by management, which have to be verified by the auditor.[94] In these cases auditors are required to notify the FSA if they intend to qualify the accounts in accordance with sections 235(2)(3) and 237 of the Companies Act 1985.[95] The bank would also have to consider whether it should notify the FSA of a possible qualification of their annual financial statements, even if the qualification is no more than a comment on an aspect of its accounts.[96] The impact of qualification can be very serious for any company, but more so in the case of banks. The reluctance to qualify financial statements raises serious dilemma for auditors, especially when a problem arises six months after an audit and losses are exposed, or worse, the institution collapses. Normally, qualification of accounts is permissible only after extensive discussions with management, and then only if they fail to implement the appropriate solutions.

However, the process of qualification in the case of banks is not so simple. Auditors are required to participate in trilateral discussions (with the FSA and the

[91] These standards governed the audit for 1988 and have been subsequently proceeded.
[92] *Spicer and Oppenheim,* (04/97), op. cit., n. 90, at para., 31
[93] For a general but yet extensive examination of the issues see: J Loftus and M C Miller et al, 'Revealing Financial Vulnerability: The Waxing and Waning of Regulatory Efforts to Reduce the Accounting Expectations Gap,' Conference Paper, *Critical Perspectives on Accounting*, (1998)
[94] APB, Statement of Auditing Standards, *The Going Concern Basis in Financial Statements*, SAS 130
[95] SUP 3: Auditors, para., 3.2.2G
[96] Ibid., 3.7.2G

authorised institution) held after the auditors have issued their report on a bank's accounts. Despite the concerns expressed by the auditors of BCCI, that bank's accounts were not qualified. The issue of the qualification of bank financial statements is a crucial issue that requires consideration during the auditing process. According to Plaistowe of the ICA, the possibility of causing a run on a bank 'is always a question which you have to have in your mind when you are auditing a bank'. However, 'if any auditor were in a position that he had doubts about the accounts of a company such that he wanted to qualify those accounts then that is, indeed, what he should do'. [97] The question of qualification is raised by material misstatements that come to light in the audit process. However, the general consensus in the case of BCCI is that the extent of the fraud and its deliberate concealment was such that it was too much to ask of the auditors and the supervisors that they 'uncover the deliberate and well designed fraud'.[98]

The going-concern standard[99] also raises equally serious consequences for banks and the reputation of auditors when institutions fail. This causes a difficult dilemma for auditors about whether to qualify. Qualifying can have a devastating effect, but in some ways it maintains the credibility of the auditor, while not qualifying may result in a loss of credibility. In many ways the reporting of whether the company is a going concern brings to the fore the importance attached to the role of an auditor and re-emphasises public concern for the auditor's assurances regarding the accounts; warnings given in financial statements must surely make for better investment decisions and market discipline. More importantly, it should force the auditor to be more proactive in terms of the audit and provide constructive assurance to the market that the financial statements made by the institution are reliable. The auditor's commercial interests would dictate that the threat of qualifying the accounts would mean the potential loss of the audit engagement, which would obviously place pressure on the auditor to provide some solution to resolve the problems.

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[97] Treasury and Civil Service Committee, Banking Supervision and BCCI: International and National Regulation, Minutes of Evidence, Wednesday 29th January 1992 *The Institute of Chartered Accountants in England and Wales (ICAEW) Mr W I D Plaistowe, Mr P R Chapman and Mr B R Nelson,* London, HMSO at p. 31 question., 106

[98] The Treasury Select Committee relied on Price Waterhouse's argument that "even the best planned and executed audit will not necessarily discover a sophisticated fraud, especially one where there is collusion at the highest level of management and with third parties". Fourth Report, Evidence p. 59-60 cited p. xvii

[99] APB, Statement of Accounting Standards, SAS 130 *Going Concern*

### 6.7.1 The Auditors' Right and Duty to Report

Under the FSMA 2000, auditors have to co-operate with the FSA in the discharge of their responsibilities in an independent manner.[100] Auditors' duty to inform the FSA about matters of non-compliance at authorised institutions was not assumed willingly by the profession.

The concerns arising from the JMB collapse culminated in replacing the Banking Act 1979 with the Banking Act 1987.[101] This included the introduction of a right to communicate any matter that the auditor becomes aware of in the business or affairs of an institution. Following the recent bank failures, the question continually asked is whether auditors have a duty to detect fraud or other irregularities that can cause material misstatements in the financial accounts of banks. This has been a persistent problem for a regulator who relies on audits, even though the ultimate responsibility for bank failures lies with the board of directors and senior management. The relationship between the auditor and the client has traditionally been one of confidentiality, under which the auditor does not have the authority to communicate his findings to others.

The role of auditor and reporting accountant in the regulated sector has been altered, such that an auditor is now a quasi-regulatory officer inasmuch as he is a 'skilled person' in the sense of s.39 of the Control Reports (now s.166, Control Reports') with responsibilities in an auditing process to shareholders, depositors and the wider public interest. This particular part of the responsibility gives the auditor the authority to act on behalf of the Bank and the FSA to ensure regulatory compliance. In many respects the imposition of additional powers on the auditor and reporting accountant maintains the existing relationship of regulator, the regulated and the regulator's style of supervision: it requires the auditor to protect the public interest even as he is doing his duty to his client. This does not impose on the auditor any further duty in respect of detection and reporting of fraud. The exercise of a right and

[100] FSMA 2000 s. 342(6) SUP 3.8.5R

[101] *The Committee set up to consider the system of banking supervision*, Cmnd 9550, HMSO, June, (1985)

then a duty to report has essentially stemmed from the failures referred to above, in particular, JMB and BCCI.[102]

Initially, the requirement for communication between the auditor and regulator through the audit or *ad hoc* reports conducted by reporting accountants was not accepted with open arms by the profession, but this became the compromise that relieved it of the duty to detect and report fraud to the regulatory authorities. The Bank and a working party set up by the ICAEW under the chairmanship of Lord Benson discussed the problems in imposing a duty on the auditor to detect and report fraud without the knowledge of his client, and considered the costs of imposing such a duty. However, pressure to impose that duty grew after the demise of BCCI and the fraud which was discovered. Recommendation to extend the scope of the duty was made by Lord Bingham in the BCCI Report, and was met with some opposition from the profession, which defended the status quo. The auditor and reporting accountants were required, under s.47 of the Banking Act 1987, to prepare a report, and with it as the means, to communicate in good faith with the FSA when circumstances 'of material significance'[103] arise, without breaching their duty of confidentiality to the authorised institution under audit.[104] The question of whether an issue is of 'material significance' is relative to its potential impact on the regulated entity[105]. With the implementation of the post- BCCI Directive,[106] the auditor and reporting accountant were under duty to report when auditing the financial statements of entities deemed 'closely linked by control' to the entity that is regulated.[107] Under the Regulation[108] 'closely linked' institutions are those that have a subsidiary/parent relationship in which the subsidiary is under the direction of the parent entity being regulated and is accustomed to act in

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[102] Memorandum submitted by The Institute of Chartered Accountants in England and Wales (ICAEW) Minutes if Evidence taken before the Treasury and Civil Service Committee. Wednesday 29 January, (1992), at p. 25

[103] APB, Statement of Auditing Standards *The auditors' right and duty to report to regulators in the financial sector*, [SAS 620] (Issued March 1994)

[104] The duty of confidentiality is an implied duty in the relationship between an auditor and the reporting accountant and their client.

[105] Material Significance: the term "material significance" requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator. Further guidance on the interpretation of the terms in the context of specific legislation is contained in Practice Notes dealing with the rights and duties of auditors of regulated entities to report direct to regulators.

[106] Financial Institution (Prudential Supervision) Regulations 1996

[107] This is now governed by FSMA 2000 s. 343

accordance with the parent entity's directions. The information to be communicated to the FSA relates to the parent entity under audit. Unfortunately, the post-BCCI Directive is not without shortcomings. For example, it does not define 'material significance'. According to Practice Note 3, auditors or reporting accountants are to exercise their judgement as to whether a matter is of material significance by considering its capacity for compliance with Schedule 3 of the Minimum Criteria for Authorisation set out in the Banking Act 1987. In doing this, they were not to extend their procedures, but rather, they were to obtain evidence of compliance and non-compliance in the course of their normal procedures.[109]

### 6.8 The Role of the Reporting Accountants (Skilled Person)

The role of the reporting accountant has become an integral part of banking supervision, so much so that it will be integrated into the entire regulated sector. The FSA has perpetuated the role in banking supervision and introduced it into the supervision of Building Societies. Under s.66 FSMA 2000, the FSA has the authority to notify a 'skilled person' (reporting accountant) to provide it with 'a report on any matter about which the Authority has required or could require the provision of information or production of documents under s.165'. The power of s.66 is similar to that of s.39 of the Banking Act 1987, under which the appointment of the skilled person is, like the external auditor's, a contractual appointment. But the difference introduced by s.66 is that this appointment has a clear regulatory purpose.[110] The authorised institution would commission the report by letter of engagement with the reporting accountants, and in similar circumstances, the report that is completed by the reporting accountant is addressed to the directors. The FSA clearly has the power to initiate a report on any matter and to determine the scope of the report to be made by the skilled person/reporting accountant.[111] This section focuses on the salient features of the skilled person/reporting accountant's role, and more importantly, considers whether a duty of care could be owed to the FSA in the preparation of reports. The latter possibility can be inferred from the decision of Lord Woolf in *Law Society v KPMG*.[112]

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[108] The Accountants (Banking Act 1987) Regulations
[109] SUP 5
[110] Ibid., 5.5
[111] SUP.5.4
[112] *Law Society v KPMG Peat Marwick and Others*, The Times, 6 July 2000

### 6.8.1 Reporting Accountants and Duty of Care

The question of whether the reporting accountant is immune from a negligence suit is considered in *Law Society v KPMG*. This inevitably requires consideration of *Caparo*[113] and the decision in *Hedley Byrne*.[114] The Court of Appeal decision in *Law Society v KPMG* affirmed Vice Chancellor Sir Richard Scott's decision and cemented ~~s~~ in principle the incremental approach to the expansion of the tort of negligence and the closure of the floodgates against claims for economic loss by restricting duty of care to cases where it is fair, just and reasonable.[115]

The central issue in that case was whether the defendant's actions, subject of an allegation of negligence, had any causative connection with the payment from the Compensation fund. To consider this allegation the Vice Chancellor applied the criteria in *Caparo* for establishing whether a duty of care exists:

- reasonable foreseeability of loss or damage;
- sufficient proximity of relationship;
- whether the expectation of duty of care is fair, just and reasonable.

Failure to qualify the report led to the continued malpractice at the firm of solicitors, thus preventing the Law Society from intervening to prevent the damage. According to the Vice Chancellor, the relationship between the reporting accountant and the Law Society was 'sufficiently proximate' to warrant due care. In this case, it was argued that in the light of certain provisions of the Solicitors Act 1974 the reporting accountant had a responsibility to alert the Law Society to the possibility of improprieties in the conduct of the solicitor's practice, and that those improprieties could lead to claims for compensation.[116] The Court of Appeal was of the same opinion as the Vice Chancellor about the criteria appropriate for assessing the preliminary issues and on that the allegation (that lack of due care caused loss to the compensation fund) is for the jury to arbitrate.[117]

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[113] *Caparo* [1990] op. cit., n.38 at p.568
[114] [1964] AC 465 at p. 528-529
[115] Case Report: *Law Society v KPMG Peat Marwick* Court of Appeal, 29th June 2000 Vol. 16, No. 3, *Professional Negligence*, (2000) 186-193
[116] Ibid., at p. 187
[117] Ibid., at p. 189

The most problematic issue in determining whether a duty of care exists is whether the expectation of due care is just and reasonable. This requires consideration of policy to determine whether it is necessary to expand the incremental approach of the tort to encapsulate the relationship between the Law Society and reporting accountant. The Vice Chancellor made the following points: damages arose only from the undetected misappropriation of funds, which consequently led to the loss to the compensation fund; the fact that such reports were annual meant the unqualified report would have gone undetected until the next report detected the misappropriation. In the words of the Vice Chancellor, the negligence would not have been 'open-ended as to time', therefore limiting the recoverable loss.

The context of the decision in this case is all-important. The regulatory regime governed by the Law Society has a number of functions similar to other regulators', such as the FSA, and a number of inferences can be drawn from the reasoning to suggest that reporting accountants in the banking supervisory regime could be equally liable. The role of the reporting accountant is governed by the guidance notes discussed above, which specify what the FSA requires in those reports. They also clearly indicate that the FSA will exercise its regulatory judgement on the basis of the information provided. The reports not only form the basis for decision-making in terms of supervision but also the FSA's enforcement decisions, and they assist the FSA in determining whether to intervene to ensure compliance, or in severe cases, to revoke or restrict authorisation.[118] Reporting accountants' failure to qualify their reports or to exercise due care by overlooking significant material misstatements could lead to losses for depositors or investors if the FSA does not intervene. This shows that if a material misstatement that clearly should have been identified is not identified, the institution's authorisation is jeopardised, before the FSA has the opportunity to intervene to ensure compliance or to exercise its other powers to mitigate the losses that might occur. Moreover, though s.1 of the FSMA 2000 confers a general duty upon the FSA to protect consumers, this duty is a function in the view of the statutory law, and as such, immune to suits of negligence from depositors or investors.[119] The loss would have been recoverable under the Compensation Scheme s.212 of the FSMA 2000 governing regulated activities and would be payable to

[118] Chapter 5 Enforcement Methods and Sanctions in Banking Regulation and Supervision

depositors on the insolvency of an authorised institution. The appropriate proximity arises when the loss is covered by the compensation fund. This provides the 'sufficient proximity' between the accountant and the regulator condition because the report prevented the regulator from exercising the relevant powers. The decision in this case provides substantial pressure on reporting accountants to ensure that they act with appropriate professionalism when undertaking such assignments because of the potential repercussion from not acting with appropriate due care in their quasi-regulatory role of auditors/reporting accountants.

### 6.9 The Ethical Guidelines for the Audit Profession

The question of independence remains a central concern of the statutory audit. An independent audit fulfils an essential role not only for the shareholders/regulators but also for the wider market participants in providing accurate information about a company. Moreover, it should provide the regulatory authorities independent assessment of the business activities of the regulated firms. The issue of independence is much wider and prevalent in auditing and the provision of non-audit services. According to the European Commission[120] and the US,[121] independence consists of both 'mind and appearance' to satisfy the scrutiny of a third party and ensure the objectivity and the integrity of the statutory audit conducted by the auditor. This is because the perception in the market is that the audit statement is independent and provided with impartial judgement as to how the company is performing. This perception can only be maintained if the auditor is considered to be free from conflicting interests and influences. The auditor is required to comply with ethical

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[119] See Chapter 7 Accountability of Regulatory Decisions at p. 264

[120] Commission of the European Communities, *Communication from the Commission, Accounting Harmonisation: A new Strategy vis-à-vis International Harmonisation*, Brussels Com (95) 508 final (14.11.1995). Commission of the European Communities, Green Paper, *The Role, The Position and the Liability of the Statutory Auditor within the European Union*, Brussels Com (96) 338 final 24/7/96. Commission of the European Communities, 'Communication from the Commission on the statutory audit in the European Union: the way forward,' Official Journal of the European Communities, (98/C 143/03), C143/12, 8.5.98

[121] GAO, *The Accounting Profession. Major Issues: Progress and Concerns*. Washington DC, General Accounting Office (1996) GAO/AIMD-96-98. See also: B Edward Committee, 'Independence of Accountants and Legislative Intent,' 41 *Administrative Law Review*, Winter, (1989), 33. J A Siliciano, 'Trends in Independent Auditor Liability: The Emgerence of a Sane Consensus? 16 *Journal of Accounting and Public Policy*, (1997), 339-353. C B Cloyd et al, *'Independent auditor Litigation: Recent events and related research,'* 17, *Journal of Accounting and Public Policy*, (1998), 121-142

standards that underpin the audit process to examine the financial statements.[122] As with the guidelines and standards, the ethical guidelines are enforceable by the JDS.

The statutory audit gives confidence to interested parties, and it is important that statutory and professional guidelines ensure that the objectivity and integrity of the audit can be safeguarded. The literal meaning of 'independence' focuses on a party's not being dependent on another's 'authority or control', and on an unwillingness to be under an obligation to others.[123] 'Independence', therefore suggests clear autonomous existence. According to Devlin J (as he then was):

> *"[I]ndependence ordinarily denotes financial independence, but I do not think that is the only sense in which the word can be used. I think that the word may be used to refer to a person who is permitted-and, perhaps, indeed required-by the man who employs or retains him to bring an independent mind to bear on a particular problem..."*[124]

The legal definition highlights the importance of financial independence; this is a crucial part of the requirements for auditor independence. Moreover, the idea of an 'independent mind' is similar also to the generally accepted interpretation of 'independence' by the accountancy profession. Consequently, Devlin's definition suggests that the notion of independence can only be judged in terms of activity rather than simply in terms of appointment. In such circumstances, independence can be assessed subjectively in terms of the state of mind and the public's expectation of an audit because an audit can be undermined by a lack of confidence in it. It does appear that the latter concern is something the ethical guidelines attempt to identify as part-and-parcel of the auditor's public responsibility.

According to Brazerman, Morgan and Loewenstein it is impossible for auditors to be independent:

> *"...auditors' judgement are likely to be biased in favor of their own and their clients interests. This bias occurs indirectly as a result of selective sifting and integrating audit information. As a result, the bias is likely to be unintentional*

[122] In the Conduct of any audit of financial statements, auditors should comply with the ethical guidance issued by their relevant professional bodies (SAS 100.2)
[123] Oxford, *Compact English Dictionary*, Oxford, Oxford University Press (1996) at p. 504
[124] *Potato Marketing Board v Merricks* [1958] 2 All ER 538 at p. 548

*and impervious to moral suasion or the threat of delayed and probabilistic sanctions, which are likely to seem quite remote.*"[125]

It is, according to this study, psychologically impossible for even the most honest auditor to maintain objectivity. This is because bias can enter the decision-making process unintentionally or when an auditor faces a moral trade-off.[126] The suggested changes have been deemed impractical by the professions in the UK and the US. It is essentially for the profession to monitor such activities and ensure auditing firms comply with the ethical principles that underpin the audit. This can be seen by the impact of the SEC investigation into Price Waterhouse Coopers [PWC]. This report into failures relating to compliance-with-independence rules has had a huge impact on the accountancy profession in the US with the 'selling off' of consulting arms of accountancy firms, and shows that the only way to ensure independence is through external monitoring of compliance[127]. Despite the opinion of Brazerman, Morgan and Loewenstein, it is inherently difficult to establish bias against auditors; it may be possible to establish misconduct on their part.

The world of auditing is just one, albeit a central cog of the accountancy profession that consists of a number of business roles. So it is important that even when undertaking the other activities auditors ensure they are exercised with the same integrity and independence. The idea of auditor independence requires the ability to act without self-interest or in the interest of the firm but rather, objectively and impartially. The professional guidelines highlight that independence is about ensuring that the audit is undertaken with a spirit of independence i.e., with an 'independence of mind'. [128] This can be done even when the non-audit services threaten objectivity; this is legitimated by suggesting it is more appropriate in the interests of the client to have in place a broad range of safeguard procedures to offset threats to objectivity rather than restrict the benefits to a client of the profession's expertise. In such circumstances it is proposed that the auditor should ensure that the audit complies

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[125] M H Bazerman, K P Morgan, G F Loewenstein, 'The Impossibility of Auditor Independence', Summer, *Sloan Management Review*, (1997) 89-94 at p. 93

[126] For a critique of Bazerman & Loewenstein see, M E Oliverio, 'Auditor Independence: Is it Impossible' Conference Paper, *Critical Perspectives on Accounting* (1998)

[127] Report of the Internal Investigation of Independence Issues at PriceWaterHouseCoopers LLP, *In the Matter of PriceWaterhouseCoopers LLP, U.S. Securities and Exchange Commission AP File No. 3-9809*, 6th January, (2000)

with the relevant standards and guidelines so that conflicts of interests between the two activities can be reduced. This can also be assisted by an effective corporate governance system.[129].

The ethical principles ensure that the engagement partner responsible for the audit recognises the importance of undertaking an examination critically and with professional scepticism, highlighting the importance of being objective and independent, and not to assume that the information provided is necessarily accurate. The audit is governed by broad principles rather than prescriptive rules, thus avoiding a legalistic approach, and essentially builds upon the SAS's principles. The broad principles outline the general requisites of professional behaviour and are therefore a guide to professional ethics.[130] Threats are considered to be those factors which can affect the auditor/auditee relationship and could undermine the integrity and objectivity of the audit.[131] The issues of concern are the problems of familiarity and reliance on management rather than objective scrutiny. Moreover, it identifies particular precautionary measures that can be exercised to preserve the objectivity and independence of the audit by implementing safeguard procedures to ensure that the auditor recognises his moral and professional responsibility for ensuring the credibility of a firm and of the profession's reputation.[132] To control and mitigate threats, steps need to be taken to ensure there are review procedures in place that are independent of the engagement partner. The ultimate sanction when instances of non-compliance with Audit Regulations are discovered should be disciplinary action.

The guide identifies specific risks in the relationship between the engagement partner/firm and the client[133] that could threaten the objectivity and independence of

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[128] ICAEW, 'Guide to Professional Ethics, Statement 1.200 and Statement 1.201, Integrity, Objectivity and Independence (1999)

[129] S A Zeff, 'Independence and Standard Setting,' 9, *Critical Perspectives on Accounting*, (1998), 535-543

[130] The Institute of Chartered Accountants in England and Wales, *Guide to Professional Ethics,* (1999)

[131] Ibid., at para., 1.6:

- The self interest threat
- The self review threat
- The advocacy threat
- The familiarity or trust threat
- The intimidation threat

[132] Ibid., at para., 3.0

[133] Ibid., at para., 4.0

an audit. The risks highlighted again bring to the fore the concern about over-familiarity with and over-reliance on a client. Both can undermine the independence of the audit. Two in particular: the provision of non-audit services and length of service, raises the most concerns in terms of their effect on the integrity of the audit.

The main reasons for the use of non-audit services relate to cost-reduction and to improvement of informedness about a company. The industry highlights the adverse effect of not providing such services[134]. The guidelines do not identify which services could lead to an undermining of independence. However, whilst there are advantages there are also clear disadvantages, such as a lack of independence from the client because of an involvement in the client company that can diminish the likelihood of self-assessment of prior work.[135]

A survey by the magazine *Financial Director* shows that the fees derived from audit clients in terms of non-audit services are significant in comparison with fees generated through auditing[136]. For example, Barclays paid PWC £4.2 million in audit fees and a further £31.6 million in non-audit fees. According to Robert Bruce, the statistics from the survey highlight the concern about threats to integrity and independence with suggestions that 'the accounting firms are teetering on a single and very unsafe pillar'.[137] Others suggest that this is due to the pressure of the quest for clients in a competitive the market.[138] This could therefore mean that concern for the audit fee can make the auditor more an advocate for the firm than an appropriately objective professional.[139] Accounting firms on occasion set audit fees at less than the market rate, which is 'low-balling' to secure audit contracts, and they simply compensate for their low rate by providing non-audit services. A number of studies have been undertaken into this issue and the general conclusion is that low-balling

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[134] Ibid., at para., 4.56

[135] R A Shockley, 'Perceptions of Auditors' Independence: An Empirical Analysis,' Vol. 56 *Accountancy Review*, (1981), 785-802

[136] 'Financial Director' Magazine (1999)

[137] R Bruce, 'Auditors run the risk of taking their eye off the ball,' The Times, October 28 (1999), 4

[138] D Ridyard and J D Bolle, 'Competition and the Regulation of Auditor Independence in the EC,' Vol.1, No.2, *The International Journal of Regulatory Law & Practice*, (1993), 163-169

[139] The European Commission, Green Paper, Com (96) 338 final. This highlights the concern relating to assessing the cost and tendering for an audit at the lowest cost to secure business and then recouping the shortfall from non-audit services.

could cause a decline in the quality of audit work with its tendency to reduce the number of actual auditing hours put into an assignment.[140]

Such concerns can only raise more problems when an auditor fulfils a quasi-regulatory role, as non-audit/regulatory activities may not take into account the consequences of their services in terms of regulatory interests and concerns, even though in theory they should. This is clearly established with the closure of BCCI. Price Waterhouse had advised BCCI to move its Treasury operations to avoid tax liabilities relating to Treasury losses. This episode clearly highlights the conflicts of interests that can arise between the audit/regulatory responsibilities and commercial interests. The establishment of the central Treasury in Abu Dhabi was strongly criticised in the Bingham Report, according to which the move was like placing "a refractory pupil...in a dark corner at the back. [141]" This attitude is clear in the Sandstorm Report produced under section 41 by Price Waterhouse for the Bank:

> "*3.9. A further feature arising from the review of Treasury operations in 1985 was the potential liability to the Corporation Tax arising from the Division's activities in the period 1982 to 1985. Following advice from ourselves and from the Tax Counsel during 1986 it was determined that this liability could be significantly reduced if the Bank ceased trading in the United Kingdom and claimed a terminal loss. As a consequence of this advice, the Treasury activities were moved from London to Abu Dhabi with effect from 31 October 1986. Price Waterhouse assisted with the Transfer from London to Abu Dhabi and we are pleased to report that the transfer was conducted smoothly.*"[142]

The Sandstorm Report, published in the US, shows how the provision of non-audit services can create regulatory problems and thus undermine the notion of functioning in the public interest when the commercial nature of auditing apparently overrides it. Whilst this may be deemed efficient, it clearly raises a conflict of

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[140] M Ezzamel et al, 'Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship between the Pricing of Audit and Non-audit Services,' Vol. 27, No. 1, *Accounting and Business Research*, (1996), 3-16; L Barkess & R Simnett, 'The Provision of Other Services by Auditors: Independence and Pricing Issues,' Vol. 24 No. 94, (1994), 99-108. U.S Research: L DeAngelo, 'Auditor Independence, "Lowballing", and Disclosure Regulation,' Vol. 3, No. 3, *Journal of Accounting and Economics*, (1981), 113-127; C J Lee & Z Gu, 'Low Balling, Legal Liability and Auditor Independence,' Vol. 73, No. 4, *The Accounting Review*, (1998), 533-555; A Gregory & P Collier, 'Audit Fees & Auditor Change; An Investigation of the Persistence of Fee Reduction by Type of Change,' 23(1) *Journal of Business Finance & Accounting*, (1996) 13-28

[141] *Inquiry into the Supervision of the Bank of Credit and Commerce International*, The Right Honourable Lord Justice Bingham, House of Commons, HMSO July 1992

interests between the regulatory and other roles of the auditor and the firm, causing concern about undermining the interests of depositors. Notwithstanding the knowledge spill-over from non-audit services, it would be appropriate for the audit and non-audit functions to take a holistic approach to the business organisation rather an independent and possibly conflicting views. It should be a regulatory requirement that at the Trilateral meeting the provision of audit and non-audit services are discussed, and in particular, the way the authorised institution has addressed issues that have raised the concern of auditor independence. This would ensure that regulators are aware of the size of non-audit services in comparison to the audit and can then deal with issues that have indirect regulatory consequences.

### 6.9.1 The Role of Skilled Persons/Reporting Accountant: The Potential Conflicts of Interest

The role of the reporting accountants is essentially built upon their duty under s.166 of the FSMA 2000 to report. Whilst the reporting accountants are usually approved by the FSA, they are more often than not the auditors of the authorised institution. The auditors and reporting accountants express their opinion and report at the bilateral or trilateral discussion.[143] The meeting addresses a wide range of issues that the FSA notes in its assessment of an authorised institution and the work done by the auditor and reporting accountants. The roles of the auditor and reporting accountant raises particular issues relating to independence and the potential for conflict of interest in the supervision of authorised institutions, particularly since they are distinct roles that nevertheless overlap at times. The two roles raise questions about independence and conflict of interest, particularly about the non-audit functions that the reporting-accountant role performs with regard to its responsibilities for reporting on matters to do with internal controls and prudential returns. Under the Companies Act 1985 (of which the relevant section was repealed by s.46 of the Banking Act 1987) and now under s.344-346 of the FSMA 2000, some of the activities required in the reporting role can be regarded as breaches of the Accounting Professions Ethical Standards that can incur sanctions.

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[142] Minutes of the Meeting with Price Waterhouse posted at http: www.csustan.edu/aaba/aaba.htm at p.175

[143] Whilst the both forms of meeting are held annually the auditors and reporting accountants can initiate meeting when necessary, these will normally arise when their right or duty arises or when a negative opinion arises. Section 4 at para., 5

The concerns about these conflicts of interest are real and have been highlighted by the Arthur Andersen Report, which noted the concern of staff at Supervision and Surveillance about the independence of reporting accountants.[144] To have the role of reporting accountant and auditor performed by the same firm has been encouraged by the Bank and continues to be encouraged. The Bank's approach was based on the argument that the two roles lead to greater efficiency because of the prior knowledge of the client. Although the reporting accountant's role did not figure in the Baring debacle, according to the Treasury Select Committee the weaknesses that transpired after the collapse of Barings bank questioned the capacity of a firm to provide both auditing roles. The Committee recommended that the Bank use a different firm, fully independent from the auditors of the financial statements, to conduct the s.39 reports (Banking Act 1987). However, there is support for the opinion that the roles of the auditor and reporting accountant are essentially the same roles.

The FSA under the FSMA 2000 provides rules governing the appointment of auditors and reporting accountants its Supervision Manual.[145] The measures adopted by the FSA go some way to reducing the likelihood of a conflict of interest when skilled persons are required act objectively when assessing matters in which they were active in another capacity, for example, as auditors.[146] SUP 3 stresses the importance of undertaking audit work independently and avoiding conflict of interests with the firm. The FSA bases the decision as to whether the auditor breaches the independence by referring to the ethical guidance provided by the profession. Therefore, the onus is on the firm, i.e. authorised institution, to ensure that steps are taken so that it has an auditor independent of the firm. These proposals go some way to place the issue of independence on the regulatory agenda but the current internal arrangements may not necessarily ensure auditor independence.

### 6.10 Alternative Mechanisms of Ensuring Independence

The audit can have various built-in mechanisms to ensure some form of independence, such as the right to obtain information ('the audit evidence'). The other

[144]Arthur Andersen, *Findings and Recommendations of the Review of Supervision and Surveillance* July (1996) at p. 13, para., 68
[145] SUP 3.5 and SUP 5.4.8

is the 'going concern' concept, which focuses the auditors mind on the future viability of the company.

### 6.10.1 Rotation of Partners

The objective judgement with which the professional decision needs to be taken can be threatened by the professional's familiarity with the client.[147] The empirical work undertaken in the US on the question of auditor rotation is somewhat unclear in terms of the effect on audit failures.[148]

While the FSA provides guidance to ensure that skilled persons are independent and impartial, it seems as though the policy of rotating partners of controlled reports has been overlooked with the more generalist approach to the policy of skilled persons. This was a feature only recently adopted into the old approach, which was to rotate audit partners with respect to s.39 Control Reports, but this was a reaction which fell short of what the Treasury Committee proposed, which was that the reporting accountant function should be undertaken by a firm of accountants separate from the auditor's firm. The requirement related to partner-equivalent roles such as audit directors or audit engagement-partners following the initiatives of the accounting profession for audit partners of listed companies to rotate after a maximum of seven years. In the case of s.39, the accounting partner is required to rotate every five years. A major problem with rotation is that s.39 reports are the work of several partners and the proposed changes only applies to those partners whose judgement is most critical (the lead partner) in the opinion expressed. Therefore, a culture of collusion and co-operation could still exist.

### 6.10.2 The Role of the Audit Committee

Studies of the role and importance of audit committees have been mixed. In many respects it is the independent function and the pro-active role of the audit committee that is of crucial significance, not simply the presence of an audit committee. Hence, the importance of a clear constitutional base for the audit

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[146] Ibid., SUP 5.4.8(5)(c)
[147] ICAEW suggest "a familiarity threat will arise": *Guide to Professional Ethics*, op. cit., n. 128 at p. 205, para., 4. 79
[148] P L Walker, 'Mandatory Auditor Rotation: Arguments and Current Evidence', Conference Paper, *Critical Perspectives on Accounting*, November 1998

committee's purpose within an organisation is paramount, one that will allow it to effectively monitor the client/audit relationship. Furthermore, the role of audit committees can only be complete if the professional bodies and even the regulatory bodies provide clear guidelines for their effective use to ensure auditor independence. A large number of studies conducted in the US have concluded that there are benefits from establishing an audit committee because they can play an important role in enhancing the public's perception of the independence and objectivity of auditors,[149] but only if the audit committee has the appropriate powers to ensure auditor independence. This was a problem identified with the Federal Deposit Insurance Corporation Improvement Act 1991 (FDICIA), which advocated the use of audit committees at large banks and thrift organisations. This was unfortunate because audit committees are known to be effective for enhancing corporate governance. Furthermore, a limitation identified by the GAO Report on the FDICIA approach was the failure to provide an effective mechanism for auditor/audit-committee relationship. The responsibility for the audit function remained with the management, which essentially perpetuates the existing relationship and does not solve the conflict of interests.[150]

The FSA does recognise the importance of having an audit committee chaired by non-executive directors.[151] This is based on guidance provided by both the Cadbury and Hampel reports. However, in the latter the focus is simply on the overall financial relationship between the company and the auditors. This does not provide any clarification of their function in terms of ensuring independent assessment of the auditor's role or the reporting accountant's role. However, some 'regulatory bite' is provided with the explicit authority to investigate matters and have the right to request information, a measure which should have been deemed mandatory rather than discretionary.[152]

[149] Federal Regulation and Regulatory Reform, Report by the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, October 1976; The Commission on Auditors' Responsibilities; Report, Conclusions and Recommendations, AICPA, 1978; Report of the National Commission on Fraudulent Financial Reporting, October 1987; CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies (GAO/AFMD-89-38, March 6 1989); and GAO, The Accounting Profession. Major Issues: Progress and Concerns, September (1996) GAO/AIMD-96-98

[150] GAO/AIMD-96-98, ibid., at p. 56

[151] IPRU, AR: 3.3.10

[152] Ibid., AR: 3.3.10(33)(d)

### 6.10.3 The Role of the Internal Auditor

The new guide to prudential supervision, unlike its predecessor, does recognise the importance of the internal audit as a mechanism to ensure the effectiveness of systems in the broadest sense.[153] Moreover, the Auditing Practices Board has recognised the importance of the internal audit and its use to the external auditor.[154] According to SAS 500:

> "*External auditors should consider the activities of internal audit and their effect, if any on external audit procedures.*"[155]

The roles of both the external and internal audit can enhance corporate governance within which the internal audit can play a possible role to ensure the independence of the external audit by assisting the audit committee with its responsibilities. The central role of the internal auditor is a broad responsibility of monitoring and reviewing the effectiveness of internal-control systems on behalf of management. The work of the internal audit can be invaluable if the external auditors take note of its findings. This was clearly a failure in the Barings debacle, where the internal-audit review of the operations relating to Leeson's activities raised a number of concerns. According to SAS 500, the complementary role should be to identify the most appropriate way of auditing the company's financial statements.[156] Notwithstanding this fact, the external auditor should determine whether the internal audit has functioned with due professional care.[157] Unfortunately, the role of external auditor does not go as far as the International Standards on Auditing, which suggest that the external auditor should test the work of the internal audit to confirm its adequacy, whereas SAS 500 requires evaluation without confirmation of whether its work is adequate. Such an evaluation includes an assessment of the work when relying on it for external audit purposes but no more than that. At this point, it is uncertain whether the external auditors for Barings undertook such procedures. If they had taken into account the work of the internal audit the risks to which the bank was being exposed by Leeson's activities would have become apparent. If the external

[153] Ibid., AR: 3.3.9
[154] APB, Statement of Auditing Standards, *Considering the work of Internal Audit*, SAS 500, APB London (Issued March 1995)
[155] Ibid., para., 2

[156] Ibid., para., 9

auditor had determined that the work of the internal audit was adequately completed, then surely such material issues would not have been over looked?

The recent proposals by the Basel Commission Paper formally recognise the value of the internal audit in the wider regulation and supervision of banking institutions.[158] The work of the internal audit centres on the most essential area to avoid loss or failure: internal controls and systems. The Basel Paper indicates that the task of both the regulator and internal audit is to deal with areas of greatest risk[159] and goes as far as suggesting that supervisors and internal auditors discuss policy issues jointly. This would complement the role of the internal auditor's responsibility for controls and systems. Moreover, the Basel Paper suggests that a trilateral meeting with the internal auditors, external auditors and the supervisory authority is organised in order to avoid duplication. The principles underlying the Basel Paper go some way to rectifying the concerns raised in this section and would, if effectively implemented, optimise supervision.

### 6.11 Conclusions

An attempt has been made to analyse how banks are prudentially regulated in terms of their capital adequacy and their fit and proper management of risk. The use of auditors and reporting accountants is clearly part of the mainstay of banking supervision, placing on the auditor a quasi-regulatory function to act for the wider public good by assisting in the supervision of authorised institutions. It is important to note that the role of an external auditor is increasingly one of assistance: Ultimately it is the responsibility of the FSA to ensure that those authorised are compliant. However, auditors are required to follow their ethical code, the breaching of which can incur sanctions.

There is an inherent conflict in this role. The relationship between the external auditor and management raises concerns about whether external auditors can perform the role required of them. These concerns stem from the way the accountancy

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[157] Ibid., para., 14

[158] Basel Committee on Banking Supervision, Consultative Paper, *Internal audit in banking organisations and the relationship of the supervisory authorities with internal and external auditors*, Basel July (2000)

[159] Ibid., at principle, 13-18

profession is run because it raises the issue of regulatory capture inherent in self-regulation. This issue is exacerbated by a system of enforcement which is seen to be ineffective, lacking in will to take appropriate enforcement measures. This also permeates the process of rule-making because the rules devised by the industry are normative and provide guidance that courts have not recognised as an instrument of legal responsibility governing third parties. Notwithstanding these broad criticisms, the reason for using external auditors is that this verification process, accepted by the financial markets which is extended into the regulatory process, legitimates regulation because it is using a market-based tool. Regulators and external auditors essentially undertake similar tasks based on trust and co-operation with management. However, the regulator is required to decide whether an institution should continue to be authorised and therefore has the ultimate responsibility for any failure. Yet fault is unevenly distributed between the parties in terms of paying compensation. For example, if a bank fails the attention will automatically focus on management and audit failings, and little fault is attributed to the regulator, who is exempt from prosecution. On the face of it, is inequitable.[160]

Banks are unique institutions in that they are vulnerable to a run if adverse opinions about them are disclosed to the capital markets and depositors, and such disclosures could result in their demise or in a risk of contagion.[161] Information about the well-being of banks has to be cautiously disclosed, hence the concern of providing an adverse opinion on a set of bank accounts. Notwithstanding this concern, measures exist to ensure that the regulator is made aware of problems during bilateral and trilateral discussions. Bilateral discussions do create a tension in the trust relationship between external auditor and management simply because the audit fee is paid by the institution and yet the auditor is discussing their private business with a third party.[162] Management will inevitably see the auditor as a person working in the interest of regulators, shareholders and depositors. In any regulatory environment the external auditor must have both interests equally in mind. This is because an adverse report would place the interests of depositors at risk, a risk which shareholders have clearly undertaken as investors. The auditor is providing a service to regulators: he must

[160] See Chapter 7 Accountability of Regulatory Decisions
[161] See Chapter 2 The Role of the Bank of England and Financial Services Authority at p. 44

assist and bridge the gaps principally in the areas of fraud and error and conflicts of interest. The cautious approach, based on remedies rather than sanctions, resembles the enforcement-style of banking supervision.

Depositors and the Government are deemed stakeholders in authorised institutions, yet the audit, governed by the Companies Act 1985, the Banking Act 1987 and the FSMA 2000, simply provides a legal duty to shareholders as a whole. The depositor and the regulator are in many respects unique, even though the bank is essentially a profit-making institution and the audit is essentially a contractual relationship. While audit firms do go to court and succeed in avoiding a finding of their negligence, they nevertheless attempt to settle out of court, on the basis the breach of audit contract. For example, Price Waterhouse paid BCCI liquidators $95 million (£60 million) and Ernst & Young paid $30 million for their part in the closure of BCCI.[163] Notwithstanding this fact, the threat of litigation does act as a deterrent because of the loss of reputation that results from badly audited failures. Increasing use of the 'naming and shaming' strategy as a sanction against non-compliant external auditors could lead to more effective audits because auditors will want to avoid such adverse publicity.

It is clear that auditing standards and guidelines provide limited assurance of the detection of fraud. Moreover, the evidence suggests that attempts to ensure that auditors are adequately sceptical requires, ironically, the profession itself to enforce the standards and guidance unless an independent body is appointed. The expectations gap will remain until the auditing profession decides that detection of fraud and error is an integral duty in the audit of company accounts. The duty to detect fraud existed historically but was later diluted by the accountancy profession. However, the public still considers it to be an inherent part of the external auditor's role.

Serious conflicts of interest exist in the provision of audit and non-audit services. Evidence suggests that the audit is a route to selling non-audit services such as information technology and management systems and controls. The key non-audit

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[162] Interview: January 25th 2001 with external auditors of institutions authorised under the Banking Act 1987

[163] 'Record BCCI Payout', Thursday November 18th *The Times*, (1999) at p. 34

service is the role of the reporting accountant. This raises serious conflicts of interests because they are external auditors providing a regulatory function. This role is purely a regulatory role, unlike the role of the auditor who produces the audit report, which is sanitised by the regulator after discussions and before it is published. This was the case with BCCI and the audit reports published by Price Waterhouse.[164] Furthermore, external auditors are advising authorised institutions to undertake particular changes which have regulatory repercussions. This was a clear problem in Price Waterhouse's advice to BCCI to move Treasury operations to Abu Dhabi for tax purposes: that had clear regulatory repercussions. It is advisable for the regulator to ensure, by monitoring the impact of non-audit management-advisory services, that they do not threaten auditor independence.

The reporting accountant is not expressly liable to the FSA or depositors, which leaves it in a position of uncertainty. However, some clarity is provided by the decision in KPMG and by the Law Society. This discourages abuse of their position of responsibility to regulators, who rely on the information they provide for regulatory decision-making. Reporting accountants will have to re-assess their position without further regulatory measures. However, this on its own does not necessarily guarantee the independence of the audit process, unless reporting accountants are required to report on the effectiveness of the audit. It is therefore crucial that effective internal mechanisms exist to ensure independence, such as the internal audit and the audit committee. While these functions are as effective as the status given them, they remain an ideal mechanism for reducing conflict. It requires the assistance of the regulator to ensure the effectiveness of those internal arrangements. Notwithstanding these internal mechanisms, there is need for more means of detecting, publicising and punishing auditors' wrongdoings. Such means would enhance audit quality because their application would have a detrimental effect on auditors' reputation in the market place.

[164] Bingham Report (1992) op. cit., n. 146, at p. 56-59

# Chapter 7

## Accountability of Regulatory Decisions

### 7.1 Introduction

The accountability of banking institutions is important in terms of the public expectations and the limits and duties of regulators. Regulators need to be seen to be accountable for their decisions, and a regulatory regime will be judged on its level of accountability. It is true to say that banking regulation and supervision depends on economic efficiency (competitive performance) achieved by the authorisation of financially stable institutions that command consumer confidence. This can be seen in terms of prudential supervision and enforcement decisions. The legitimacy of opacity of regulatory decisions in banking supervision raised the need for greater accountability and transparency of regulatory decision-making, and became a significant issue with the establishment of the FSA.

This Chapter will consider the discretionary power of the regulatory body and the effect of that on regulated institutions. Sections 2-3 will review the literature on accountability, focusing on the mechanisms of control and oversight by independent regulators (Parliament, ministerial responsibility, select committees). Sections 4 will then analyse parliamentary accountability of discretion-based decision-making, exercised by the Financial Services Authority, and traditionally, by the Bank, to see whether previous lessons regarding accountability have been addressed. It will establish that these institutions merely scratch the surface of regulatory decision-making, and in many respects, they simply legitimate their discretionary powers without effectively challenging decisions with other interests, such as consumers', in mind.

Section 7 will consider how the courts have judged the discretion-based approach in the context of financial regulation and the activities of bank supervisors, such as the Bank of England. Sections 8-11 will analyse misfeasance in public office by focusing on the BCCI affair to analyse the statutorily-directed accountability of regulators, and reflect upon whether public authorities should have implied and express immunity from the tort of negligence. Section 12 will consider liability under European Community law to assess whether it could provide effective legal redress to depositors. Section 13 will conclude.

**7.2 Accountability and its Parameters**

Accountability is generally concerned with a regulator's responsibility to provide answers to the general public or to the industry as a whole and to spell out the obligation it has and how it attempts to undertake them. According to Scott, accountability exists in a number of ways, for example, 'upward' (Parliament), 'horizontal' (parallel institutions), 'downward' (consumers).[1] The justification for accountability rests on political, constitutional or contractual grounds.[2] The literal meaning of 'accountability' focuses on providing explanations and reasons, i.e., 'explanatory accountability' for a particular decision or course of action. The public's understanding of accountability usually focuses on the outcome of explanations or reasons as some form of redress, i.e., 'amendatory accountability' that identifies fault or error by reversing a decision or by paying compensation,[3] or by providing reasons for the results it actually achieves. Those reasons may be positive (enhancing the competitive position of an industry) or negative (explaining why a particular institution is responsible for its closure or collapse).[4]

Traditionally, 'accountability' has been understood in the narrow sense of accountability to Parliament. In modern terms, accountability through direct public participation, or even industry participation, is also part of the norm. The former mechanism of accountability is the traditional form of political accountability in the interests of the electorate, or one based on the constitutional order that a responsibility is owed to the public as a whole. In this form of external accountability the minister

[1] C Scott, 'Accountability in the Regulatory State', Vol. 27, No. 1, *Journal of Law and Society*, (2000) 38-60 at p. 42; R Baldwin & M Cave, *Understanding Regulation: Theory, Strategy and Practice*, Oxford, Oxford University Press (1999) at p. 287

[2] B Smith and D C Hague (eds.), *The Dilemma of Accountability in Modern Government: Independence Versus Control* (1971) at p. 311

[3] G Marshall, *Constitutional Convention*, (1994)

[4] J F McEldowney, *Public Law*, London Sweet & Maxwell (1994); and PP Craig, *Administrative Law*, London, Sweet & Maxwell (1999)

(Treasury) is responsible for the actions of the regulator to parliament.[5] This obliges a minister to appear before a Select Committee or answer questions in Parliament. For example, a key function of independent Select Committees is to provide a specialised platform for scrutinising regulatory functions.[6] Another important institution of accountability in the case of the FSA is the general public and investors through the consumer panel and practitioner panel.

### 7.3 Independent Regulators

Independent regulatory bodies have grown in importance for a variety of reasons, the most significant being that the complexity of society requires specialised bodies to take responsibility for politically sensitive areas of governance. Another reason for their popularity is their expertise to undertake such responsibilities. The independence of the regulator is important to ensure. This requires reassurance that day-to-day responsibilities are carried out a-politically and that the general public interest is being taken into account. A broad system of accountability is required to ensure that decisions based on statute and management resources are observed efficiently and in a cost-effective manner, taking into account the compliance costs of regulation.[7] This means there is not only political accountability but also bureaucratic and professional accountability to ensure that the regulator is maintaining the interests of the public.[8] Independent regulatory bodies do create peculiar problems in terms of how independent bodies fit into the overall parliamentary structure of control. They are directly accountable to the specific ministerial department and under a general duty of care.[9]

The structure and scope of regulation and supervision result from negotiation between government departments, the regulator, the regulated and consumer (pressure) groups. This inevitably means that the objectives, principles and rules that underpin the legislative mandate are developed through a process of negotiation and

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[5] C Turpin, 'Ministerial Responsibility' in J Jowell and D Oliver (eds.), *The Changing Constitution*, Oxford, Clarendon Press (1994); R Scott, 'Ministerial Accountability', Autumn, *Public Law*, (1996) 410-426

[6] *cf* Johnson, 'Editorial', Vol. 57, *Public Administration*, (1979) 379 at p. 390

[7] J Froud and A Ogus, ''Rational' Social Regulation and Compliance Cost Assessment', Vol. 24, Summer, , *Public Administration*, (1996) 221-237

[8] P Day and R Klein, *Accountabilities: Five Public Services*, London, Tavistock (1987)

[9] *Rowling v Takaro Properties Ltd* [1988] 1 All ER 163 at p. 172; and also *Lonhro v Tebbit* [1992] 4 All ER 280

compromise rather than solely by government. The system of accountability includes *ex post facto* accountability because it can assess the effectiveness of regulatory decision-making and promote changes to the way regulation is implemented. Initially, accountability stems from the publication of the Annual Report and Accounts and other reports which identify corporate strategy. This provides Parliament with an opportunity to scrutinise the efficiency with which regulation is implemented. There is also the reactive, *ex ante*, accountability: the process in which Parliament, through the Select Committee, seeks an explanation for the failure of a regulated institution.

The governmental bodies essentially function to ensure good administration and limit the degree of maladministration which can undermine the public function of regulators. Maladministration means, in simple terms, '[the] unlawful or invalid act or omission of a public officer'. It can be a breach of a public power, negligence or misfeasance in public office arising from the arbitrary or improper function of administrative responsibilities. A number of legal statutory instruments exist to hold administrative bodies accountable for maladministration: judicial review, the tort of negligence, misfeasance in public office.[10]

### 7.4 Accountability and The Legitimacy of Discretion

The concern of administrative discretion has been the effectiveness of the measures to control and ensure accountability. In this section an attempt is made to look at the justifications for the discretion-based approach to regulation, and to consider its merits in comparison with a rules-based approach. It would be naïve to think that a regulatory approach is necessarily a rules-based approach, or that a supervisory approach is a purely discretionary-based one. The FSA is primarily a regulated-based institution.

'Rules' and 'discretion' are broad terms and not mutually exclusive. The distinction between the two forms centre on the following: Regulation is thought to be prescriptive and restrictive. Supervision respects the autonomy of management but retains the right to intervene in the managements conduct of business. Supervision,

[10] This chapter will focus on the tort of negligence and misfeasance in public office.

allows a considerable measure of judgement in decision-making, whereas regulation prescribes the manner in which decisions should be reached.

The literal meaning of 'discretion' centres on 'autonomy in decision-making' and 'acting in accordance with independent judgement'.[11] This definition highlights the liberty of an agency to act on its own reasoned judgement. According to Jowell, discretion is the 'room for decisional manoeuvre possessed by a decision-maker'.[12] Others suggest that discretion exists where the public officer has the authority to make a choice among possible choices of action or inaction,[13] depending on the options available.[14] What is often thought to be the free and flexible application of discretion by legal actors in fact is always guided and constrained to a considerable extent by rules or standards (legislation), to avoid unfettered discretion and ensure consistency and fair dealing.

The administrative body would thus have to elaborate on the mandate it has and use its powers to make and execute policy. Hence the label of *de facto* law-maker.[15] This suggests that an area may go through a process of formalisation and codification without necessarily diminishing the level of discretion in administrative decision-making. The importance of discretion centres around the complexity and uncertainty of society, requiring an administrative authority to be flexible, in order to deal with events as they arise. In such circumstances, a rules-based approach could be inappropriate because it may lead to a position where the decision-maker cannot apply or adapt the existing rule structure to remedy a situation and thus may not meet the purpose or spirit of the rule. On occasion, a situation may require the decision-maker to not only apply the rule or standard *per se* but consider the consequence of that decision and check whether the standard has been conformed to.[16] For example, this is the inference drawn from exercising the power to revoke authorisation when a

[11] Oxford Compact, English Dictionary, at p. 435
[12] J Jowell, 'The Legal Control of Administrative Discretion', *Public Law*, (1973) 178-220 at p. 179
[13] K C Davis, *Discretionary Justice: A Preliminary Enquiry*, London, Illinois University Press (1971) at p. 4
[14] D J Galligan, *Discretionary Powers, A Legal Study of Official* Discretion, Oxford, Oxford University Press (1986) at p. 9
[15] M Shapiro, 'Administrative Discretion: The Next Stage', Vol. 92, *The Yale Law Journal*, (1983) 1487-1522 at p. 1510
[16] R Baldwin & K Hawkins, 'Discretionary Justice: Davis Reconsidered', *Public Law*, (1984) 570-599 at p. 580

bank is deemed To-Big-To-Fail.[17] A large degree of flexibility would allow the decision-maker to deal with the problem at hand rather than form rules to rectify a situation; experience and expertise would be invaluable in dealing with such developments.

Those who advocate the rules-and-regulation approach suggest discretion needs to be confined, structured and checked to avoid the problems of excessive discretionary power.[18] This is notwithstanding the fact that 'absolute discretion is not an evil', but rather, needs to be justified to exist.[19] The application of this legalistic approach could mean that the decision-makers do not take note of the very factors for which it was established, such as to safeguard the public interest. This accords with Baldwin and Hawkin's argument that structuring discretion is not the 'panacea of all decision-making'. This is because the government has assigned the responsibility of decision-making to an administrative organisation which is deemed an expert body to ensure decisions capable of political and economic consequences are made with appropriate technical expertise.[20] This in mind, the issue is not whether rules should replace discretion, but to what degree should administrative bodies be flexible in their decision-making when making policy and executing particular courses of action. For a newly formed institution the scope for discretionary justice may be high because many issues may not have been contemplated.

Another issue is the transparency of the regulator's decision-making powers to ensure the regulator is effectively exercising its powers. Jowell argues that, '[o]nce policies are taken out from the ambit of discretionary application and exposed as rules, they are no longer hidden from public scrutiny'. Rules are developed so that the way the regulators exercise decision-making is deemed legitimate; rules make regulators responsible for their decisions because they provide individuals with the ability to criticise and evaluate rules in terms of their purpose.[21] The FSMA 2000 requires greater transparency from the FSA on how it makes enforcement decisions

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[17] F Soussa, 'Too Big To Fail: Moral Hazard and Unfair Competition', in L Halme, *et al*, *Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline*, London, Centre for Central Banking Studies, Bank of England (2000) at p. 5-31

[18] K C Davis, (1971), op. cit., n. 13, at p. 27

[19] K C Davis (1971), op. cit., n. 13, at p. 152

[20] R Baldwin & K Hawkins (1984) op. cit., n. 16 at p. 579

[21] J Jowell, (1973) op. cit., n. 12 at p. 188

with independent input, and thus provides a stronger demand for accountability in regulatory decision-making.

### 7.5 Legitimacy of the Bank of England's Discretion-Based Approach

The concept of discretion has been a cardinal part of central banking from its architects to the present day. According to Sayers, '[t]he essence of central banking is discretionary control of the monetary system'.[22] Discretionary control has not only permeated the Bank's responsibilities as to monetary policy, it has also filtered into the way the financial markets and its participants are supervised. The prudential supervision of banks has traditionally been characterised as based on discretion and the exercise of judgement. It has been the underlying conclusion of the many enquires undertaken that the discretion-based approach is appropriate. The inherent flexibility has been the reason for adopting such an approach in administrative bodies that have a large number of responsibilities. This section critically analyses the discretion-based approach.

The Bank, as an administrative body, developed a style of banking supervision which has come under scrutiny, particularly when banks have collapsed in the UK. Non-statutory inquiries have played a significant part in the overall accountability-process in banking regulation and supervision. These have provided a post-mortem when particular banks have been closed (BCCI) or had collapsed (Barings). These inquiries were not governed by the Tribunals and Inquiries Act 1958 nor were they commissioned under the Tribunals of Inquiry (Evidence) Act 1921. The latter would have provided an opportunity for cross- examination of witnesses, an issue considered a weakness in the Bingham Inquiry. The non-statutory inquiries and the Board of Banking Supervision have highlighted failures in the exercise of the Bank's responsibilities under the banking Acts, in particular, the administration of its policy and operational duties.[23]

The criticism that has called for improvements of the Bank's judgement but not suggested an overhaul has been relatively minor in comparison with the general

[22] R S Sayers, *Central Banking After Bagehot*, Oxford, Clarendon Press (1957) at p. 1

[23] C Hadjiemmanuil, *Banking Regulation and the Bank of England*, London Lloyds of London Press, (1996)

consensus in support of its style of banking supervision.[24] The discretion-based approach advocated by the parliamentary process has been critical of the operational ambit of the Bank's powers and its ability to detect a breach of trust and co-operation. The Arthur Andersen Report concluded that the style of supervision conducted by the Bank was effective because of the ability of the Bank to use persuasion and not just the force of law to resolve problems in markets and individual institutions without damaging confidence[25]. Moreover, the cost and allocation of resources can be important factors in a discretion-based approach compared with a rules-based approach. Subsequently, the rising costs of a rules-based approach may not outweigh the benefits that may accrue. The Report compared the rates of failure in other jurisdictions and found that the UK supervisory approach faired much better than jurisdictions that utilised a rules-based approach. (Particular attention was placed on the US approach, which advocates a rules and inspection-based approach.) Moreover, institutions found a rules-based approach was more expensive[26]. The Report concludes:

> "*[G]iven the diverse marketplace and the degree of product innovation, we do not think that a major shift to a rules-based approach would be appropriate in the UK and the key characteristics of supervisory judgement should remain paramount. It allows supervisors to exercise flexibility and respond to commercial realities. Similarly, do not recommend a move towards a fully inspection-based supervisory approach.*"[27]

The advocates of a rules-based approach suggest that rules are more appropriate because of the certainty they provide. This approach is particularly important when the standards of supervision and the action taken are not congruent, suggesting ineffective supervision. In such circumstances, the recommendations made to avoid such regulatory disasters have centred around a process which Davis refers to as 'confining, structuring and checking' discretionary decision-making so as to ensure

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[24]*Report of the Board of Banking Supervision Inquiry into the circumstances of the collapse of Barings*, Return to an order of the Honourable the House of Commons dated 18th July (1995). States that the events leading up to the collapse of Barings do not, in the view of the Board warrant any fundamental change to the framework of regulation in the UK. at p. 251, para., 14.4

[25]Arthur Andersen & Co, SC, *Findings and Recommendations of the Review of Supervision and Surveillance*, July 1996. Arthur Andersen were appointed to review Supervision and Surveillance at the Bank of England and to establish a Quality Assurance function at the Bank at p. 1

[26] Ibid., at p. 40, para., 20. Raises the concern about the possible expectations gap which can arise if a rules and inspection based approach were to be implemented.

[27] Ibid., at p. 5, para., 28

that lapses of regulatory/supervisory compliance do not go undetected. The need for transparency in the Bank's decision-making was never more prominent than after the Barings collapse. The Bank undertook a re-structuring of its discretionary decision-making and re-assessed its resources of supervision and surveillance by attempting to identify its objectives in supervision and to implement a risk-based approach to aid its judgement-based approach.[28] However, the decision to transfer banking supervision was made in 1997 before the changes could be assessed.

### 7.5.1 The Treasury Select Committee

The Treasury and Civil Service Select Committee (Select Committee) have traditionally had the responsibility of scrutinising the affairs of financial and banking regulators. It has the power to request parties to stand before it and submit evidence, and be held accountable to Parliament. The Committee has played a particularly influential role in investigating and disseminating evidence which arises from either a review or investigation of some financial regulatory failure. The Select Committee provides a channel for the scrutiny of the actions and encourages improvement in financial regulation and banking supervision. The Select Committee has traditionally suggested that supervisors pay more attention to the commercial realities and market behaviour and to enhance the effectiveness of the judgement-based approach. The recommendations, which have arisen from bank collapses have not attempted to curtail the exercise of discretionary decision-making but encouraged the process of 'clarity'. The process of 'clarifying' the terms of banking regulation and supervision originate from the secondary banking crisis. The formalisation of regulation and supervision still allowed the Bank to retain its anti-formalistic approach. For example, the rescue of JMB was within the discretionary powers of the Governor, notwithstanding the fact that the Bank had no formal power to rescue.[29] The Committee has contributed to the process of clarifying and structuring discretionary decision-making in order to legitimate its existence. In the history of the Bank of England, very little criticism has been levelled at the Bank's decision-making process: even the Treasury did not involve itself in changing the process of supervision.

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[28] Bank of England, 'The Objectives, Standards and Processes of Banking Supervision. Supervision and Surveillance', February (1997)

[29] Ian Stewart, H C ($6^{th}$. Ser) Vol. 83, col., 1450

## 7.6 Accountability of the Financial Services Authority

The unique way the FSA is incorporated as a private company limited by guarantee[30] implies that regulation is endogenous: essentially rooted within the market and detached from government intervention in terms of its day-to-day responsibilities. However, the fact remains that, like any other body exercising public functions, it is accountable to Parliament and the judiciary.[31]

The size of the FSA and the number of industries it is now responsible for means that different concerns are raised about the variety of rules it makes and about its broad enforcement powers.[32] The industries now regulated by the FSA have traditionally been regulated separately and developed their own distinct forms of regulatory culture and particular forms of accountability.[33] The new regulatory regime has evolved from the good practice of the previous SROs and other regulators that had modernised the regulatory regime.[34] The establishment of the FSA introduced a number of new and revised methods of accountability that have resulted in a system that is more accountable than some had feared it would be. Indeed, some thought that it would 'be the most powerful and the least accountable institution created in the UK since the War'.[35]

The FSA functions at arms length from the Treasury, even though the Treasury retains overall responsibility of the activities of the FSA and the financial markets. The Treasury has a number of 'holds' on the FSA pursuant of s.2 of the FSMA 2000, where its general duties are listed. The FSA submits its annual report (including a report by the non-executive directors) to the Treasury for examination. It is then the responsibility of the Treasury to submit that report to Parliament.[36] The

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[30] FSMA 2000 s. 1

[31] For an analysis of the status of the FSA see: The Law Society Policy Directorate. *Memorandum of the Law Society "Financial Services and Market Bill" Memorandum by the Company Law Committee* November 1998 No. 367. at para., 2.1. See also E Lomnicka, 'Making the Financial Services Authority Accountable', January, *Journal of Business Law* (2000), 65-81

[32] For a discussion as to why the FSA was established see Chapter 1 Evolution of Banking and Financial Regulation and 2 The Role of the Bank of England and The Financial Services Authority respectively.

[33] FSA, *Financial Services Authority: Meeting Our Responsibilities*, Financial Services Authority August (1998)

[34] See Chapter 1, The Evolution of Banking and Financial Regulation at p. 26

[35] M McElwee & A Tyrie MP, *Leviathan at Large: The New Regulator for the Financial Markets*, London Centre for Policy Studies (2000) at p. 1-2

[36] FSMA 2000 sch., 1 para., 10

Treasury has the responsibility also for appointing and removing the chair and the executive members of the governing board of the FSA.[37] It also commissions reports relating to the efficiency and effectiveness of the way the FSA utilises its resources,[38] and for conducting inquiries into regulatory failures that raise concerns about financial stability or undermine consumer interests.[39] The power to commission inquiries is a formal power in the new regulatory regime, not the *ad hoc* power it was under the previous one. The Treasury is given the power to decide whether to publish the report.[40]

### 7.6.1 FSA and Alternative Mechanisms of Accountability

It would be a huge misconception to think that individual interests are not in some way accountable in a regulatory environment. It is the intention of Parliament that such interests are considered by the regulators themselves on a day-to-day basis rather than have them cause court congestion. The establishment of the FSA has brought with it a change in regulatory philosophy, in addition to achieving efficiency in consumer protection. The duty of consumer protection results from the FSA's identification of the risks to which consumers are exposed, such as prudential, bad faith, complexity/unsuitability and performance risks. These risks are the broad types of risk that motivate consumers to exercise their legal right of redress. The FSA has the objective also of enhancing consumer awareness of the types of risk they need to assess in making financial decisions. Whilst the general regulatory order is to safeguard the public interest through prudential regulation, to ensure the safety of the financial system, and to make sure that regulatory failures do not cause financial instability, the regulatory order also consists of conduct-of- business rules to ensure consumers are not exploited.

The establishment of the FSA has brought a new all-embracing form of *ex post facto* accountability to the regulation of the financial sector. The Government proposed a number of measures to ensure that the FSA acts fairly, reasonably and with appropriate measures to ensure its accountability. These include not only the

[37] Ibid., sch., 1 para., 2 & 3
[38] Ibid., s. 12
[39] Ibid., s. 14
[40] Ibid., s. 17

traditional lines of accountability to parliament through the Ombudsman,[41] but also new forms of accountability, such as the establishment of a practitioner panel and consumer panel and an independent complaints commissioner.

The establishment of the single regulator required that a single Ombudsman Scheme be set-up. The Financial Ombudsman Service (FOS), formerly the FSOS,[42] is expected to deal with tens of thousands of consumer complaints. The Ombudsman Scheme has been in place for a number of years in the UK, its central function being the investigation of complaints from consumers about 'mis-selling, unsuitable advice, unfair treatment, maladministration, misleading advertising, delay and poor service'.[43] Several Ombudsman Schemes have been functioning under the previous regulatory systems for the various parts of the financial services industry.

The FOS is a body corporate licensed to operate in an independent manner, with the following aims: to provide accessible dispute resolution in a timely and cost effective manner, and to provide this service to all sections of the community, with the appropriate level of trust and respect. The FOS provides the bridge between the consumer and the financial-services institutions in dealing with complaints that have not been resolved to the satisfaction of the complainant. The scheme governs the majority of the activities regulated by the FSMA, under which the FOS has a 'compulsory jurisdiction',[44] and a 'voluntary jurisdiction'.[45] The FOS is to act in a 'fair and reasonable' manner[46] by taking into account the relevant laws and regulations, but the principle of *caveat emptor* will still apply to contracts. In such circumstances the Ombudsman has the power to order the firm to grant an award to the aggrieved consumer to cover the loss or damage, or a without money award. The FSA has limited orders-for-payment that the FOS makes to £100,000. This limit is open to review by the FSA.[47] The FOS has its own powers to investigate and

[41] See 9th Sitting of Standing Committee A
[42] FSMA 2000 s. 225
[43] FSA, *Financial Services Authority and Financial Services Ombudsman Scheme: Consumer Complaints and the New Single Ombudsman Scheme*, Consultation Paper 33, Financial Services Authority, November (1999)
[44] FSMA 2000 s. 226
[45] Ibid., s. 227
[46] Ibid., s. 228
[47] Ibid., s. 229

determine the outcome of a complaint by requiring the parties provide it with the appropriate information.[48]

The independent Complaints Commissioner[49] (the Commissioner) is an interesting introduction to the accountability regime that did not exist under the previous regulatory order.[50] It was introduced to improve the accountability process by ensuring maladministration does not damage the interests of those for whom the FSA is responsible. The function of the Commissioner is to investigate complaints against the FSA arising, for example, from a lack of care or integrity.[51] The Complaints Commissioner functions alongside the Financial Services and Markets Tribunal rather than with it: This is because the functions of the Commissioner are to investigate procedural failures rather than the FSA's legislative functions. Reference can be made to the Tribunal if the decision following an investigation by the Complaint's Commissioner is not deemed satisfactory to the parties. Moreover, the investigator is an independent party but with access to FSA resources for the purposes of his work. The complaints may be directed to the Commissioner or given to the Commissioner by the FSA. However, if the FSA decides not to investigate, the Commissioner still retains the right to undertake the investigation. Whilst the provision gives a degree of independence, some concerns still persist, such as the possibility that complaints will be passed from the FSA to the Commissioner. It will be interesting to see whether the Commissioner will be proactive in dealing with complaints passed to it. That could ensue only if the Commissioner's complaints-process is completely independent of the FSA.

Originally, the new forms of accountability did not address the issue of recompense to people affected by the failures of the FSA. In Committee debates the Economic Secretary suggested that the FSA board may in some circumstances make *ex gratia* payments. Subsequently this was formalised as compensation for complaints to be awarded as the Commissioner thinks appropriate. This acknowledges in a small

[48] Ibid., s. 231
[49] Ibid., Sch. 1 para., 7 COAF 1
[50] Ibid., COAF 1.1.4. See also, FSA, 'Investigation of a complaint about the Financial Services Authority (FSA)', *Leaflet* published by the FSA (2001) which comes into operation 3rd September 2001
[51] Ibid., COAF 1.4.1

way that economic damage can be caused by ineffective regulation.[52] The FSA is not necessarily footing the bill for the compensation because the industry funds the regulator, and therefore it as a whole is compensating for its mistakes. To avoid suggestion of arbitrariness, it will be important to ensure proportionality and fairness in the Commissioner's decisions about compensation. It has been suggested that compensation should be given to those affected by the FSA's negligent supervision, which calls into question the FSA's immunity from action against it in the tort of negligence.[53]

### 7.7 Legal Accountability of Financial Regulators

The question of whether the Bank can be sued was finally settled by the House of Lords in the interests of the depositors who lost millions when the Bank of Credit and Commerce International (BCCI) was closed in July 1991.[54] The motion that it can be sued was carried by the House on a two-thirds majority thus bringing to an end eight years of scrutinising the tort of misfeasance in public office. In order to determine whether the plaintiffs' allegations warrant a full hearing or should be struck out on the grounds that there is no case to answer. The plaintiffs alleged that the loss to depositors resulted from the Bank's failure to carry out its responsibilities under the Banking Act 1987, and that the failure enabled BCCI to accrue losses of billions of pounds through its fraudulent activities around the globe. In the Three Rivers action, the plaintiffs sued the Bank for damages in misfeasance in public office and for inadequate implementation of the European First Banking Directive.[55]

Part One of this section reviews the *Three Rivers saga* in the light of the House of Lords' decision and examines why the plaintiffs' action was brought as a charge of misfeasance in public office rather than as a charge of negligence, and whether misfeasance is an extension of the tort of negligence. Part Two analyses the question of causation in light of the facts surrounding the closure of BCCI, and whether the action should have been struck out. Part Three investigates whether the

[52] Ibid., 1.5.18G
[53] FSMA 2000 sch. 1 para., 19(1)-(3)
[54] *Three Rivers District Council and Others v Governor and Company of the Bank of England* HL [2001] 2 All ER 513
[55] *Three Rivers DC v Bank of England* [2000] 3 All ER 1 First Council Directive of Dec 12 1977 on the co-ordination of the laws, regulations and administrative provisions relating to taking up and pursuit of the business of credit institutions (with amendments), *O.J.* L 322/30 (1977).

First Banking Directive can be understood to have created a right for depositors to sue a central bank.

To enable them to bring a case for liability in misfeasance against the Bank, the plaintiffs needed to establish the existence of either: malice evidenced by an intention to injure, or knowledge that a public officer did not have authority to act as he acted. The allegations made by the plaintiffs point to the failures of specific bank officials rather than the Bank *per se*, citing two former bank governors who acted in bad faith by: licensing BCCI in 1979 when they knew that it was unlawful to do so; shutting their eyes to what was happening at BCCI after the licence was granted; failing to effect the closure of BCCI despite information (available by the mid-eighties) that warranted its closure.[56]

The cause of action included other general issues: The Bank granted a licence to BCCI, despite the fact that it did not satisfy para 7, 8 & 10 of Schedule 2 of the Banking Act 1979 (and Schedule 3 of the Banking Act 1987). The plaintiffs alleged also that the Bank had placed too much reliance on the powers of s.3(5) of the Banking Act 1979, and later s.9(3) of the Banking Act 1987, and upon assurance from the Luxembourg Banking Commission (LBC) and the Institut Monetaire Luxembourgeois (IML) that the management and financial status of BCCI SA were both sound.

The plaintiffs further alleged that the Bank was not entitled to rely on assurance given by LBC and IML because, in its own opinion, those institutions were not competent to give assurance about BCCI's management or financial soundness: the Bank itself was dissatisfied with the supervision of BCCI SA's activities by LBC/IML. Nevertheless, the Bank permitted BCCI (Overseas) to carry on an unlicensed deposit-taking business when it knew BCCI (Overseas) Central Treasury conducted its business from 100 Leadenhall Street, London. Moreover, it permitted both BCCI SA and BCCI (Overseas) to use a banking name to which it had no entitlement in law.

### 7.7.1 Part One: The Banking Act 1987, s.1(4)

The Bank, under the Banking Act 1987, had responsibility for regulating deposit-taking institutions (banks). The powers of authorisation and supervision conferred on the Bank included a broad power to revoke or restrict the authorisation of a bank if the manner in which it conducted its business threatened in any way the interests of depositors[57]. The Bank had responsibility also for monitoring authorised institutions' co-operation and for requesting information about how an institution is governed.[58] These powers to regulate authorised institutions and safeguard the interests of depositors provide the *prima facie* case that a duty of care does exist.

Establishing a case for tort of negligence is no simple task, particularly when an action is to be brought against a regulator. One needs to establish whether a duty of care is owed to the plaintiff from which a breach of duty can arise, and that the breach of duty resulted in loss or damage of a recoverable kind. This task may seem simple, particularly when a regulatory scenario is considered, because the regulator has a statutory responsibility to regulate and supervise institutions, and a failure to exercise those responsibilities can cause loss to depositors.[59] In such actions the courts have been unwilling to establish a duty of care, let alone to hold that a breach arose and that the resultant loss is recoverable. A duty of care exists where the following factors are satisfied: 'foreseeability' of the damage, and a sufficiently 'proximate' relationship between the parties. Even where the former are established, it must be further established that it is 'just and reasonable' to impose a duty. The loss to depositors is foreseeable, but in addition to foreseeability, legal 'proximity' is required and the courts need to ask whether it is 'fair and reasonable for the duty of care to be owed to the person concerned'.[60] In such circumstances, the courts have sympathy for depositors who place their money with a bank, only to find that the bank is insolvent. The courts are not prepared to make a regulator (third party) responsible by negligence for the failures of authorised institutions that arise from their lack of prudence and carelessness.[61]

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[56] Ibid. *Three Rivers* [2000] at p. 5
[57] 1987 Act s. 11(1)(e) and s.12(2)(b). These are also elaborated upon by the Statement of Principles published in accordance with s.16(1)
[58] Ibid., s. 36-38 and Schedule 3 Minimum Criteria for Authorisation
[59] *Yeun Kun Yeu v Attorney General of Hong Kong* [1987] 2 All ER 705
[60] *Dorset Yacht Co v Home Office* [1970] AC 1004
[61] *Johnson Matthey Plc v Arthur Young and The Governor of the Bank of England* [1989] 2 All ER 105

### 7.7.2 Implied Immunity

Regulators have statutory responsibility for authorisation, supervision and enforcement. However, a miscarriage of a statutory function does not automatically give rise to private-law right to damages, unless the legislator intends to codify that class of rights. A statute must intend to give rise to specific private-law rights, not only to the general public-law rights of the Banking Act 1987.

The initial concern centres on regulatory bodies acting in a rather defensive manner. This argument was posed by those who advocated an express immunity for regulatory bodies from the tort of negligence. In *Hill*,[62] it was alleged that the police failed to apprehend the Yorkshire Ripper. Thereby prevented the murder of his last victim, the decision was that a duty of care did not obtain for reasons of public policy and in the light of a previous decision that a duty of care is not owed to individual members of the public. It was considered that the duty of care has 'an inhibiting effect on the exercise of that judgement' leading to the argument that speedy decisions would not be taken because a defensive approach is adopted. The question of resources plays an obvious part in whether or not investigations or inspections take place in a given regulatory regime.[63] Imposing a duty could also mean that regulators divert resources from other areas of regulation to simply avoid having actions taken against them. According to Lord Keith in *X Bedfordshire*, who decided that no duty care was owed with regard to children's welfare and education, it would have meant that resources would simply be used to prepare a case for defence.[64] Alternatively, as Lord Steyn decided in *Elguzouli*, they could simply act in a way to protect themselves from an action in negligence.[65] This can lead to a situation where further regulatory intervention is not actually necessary, so the costs would not justify the benefits of greater vigilance or onerous safety measures. The final policy reason is that the plaintiffs in cases such as *Stovin*[66] and *Hill*, had other means of gaining compensation for loss or damage, through private insurance or public insurance schemes respectively. In such instances, as Hoffmann LJ notes in *Stovin*, the 'denial of liability does not leave the road user unprotected' when there is compulsory insurance.

[62] *Hill v Chief Constable of West Yorkshire* [1988] 1 WLR 1049 at p. 1055
[63] Ibid., *Hill* at p. 1056
[64] *X (Minors) v Bedfordshire County Council* [1995] 3 WLR 152
[65] *Elguzouli-Daff v Commissioner of Police of the Metropolis* [1995] 2 WLR 173
[66] *Stovin v Wise* [1996] 3 WLR 388

Distinct remedies to liability for damages mean that Parliament has addressed the question of appropriate compensation. For example, in banking regulation and supervision, the Deposit Protection Scheme exists to compensate depositors for loss occasioned by the closure of a banking institution.

### 7.8 The Exception to Immunity - The Tort of Misfeasance in Public Office

The Banking Act 1987 confers an express immunity against liability from the tort of negligence with s.1(4):

> "*Neither the Bank nor any person who is a member of its Courts of Directors or who is, or is acting as, an officer or servant of the Bank shall be liable in damages for anything done or omitted in the discharge or purported discharge of the functions of the Bank under this Act unless it is shown that the act or omission was in bad faith.*"

The express immunity provided by Parliament is legitimated on similar grounds as the implied immunity conferred by the courts, to pre-empt a flood of actions against financial regulators for not allowing the recovery of pure economic losses from a regulatory body.[67]

The tort of misfeasance in public office is a remedy for acts or omissions undertaken in bad faith which no accountability process could ever reasonably legitimate. The very strict nature of misfeasance makes it difficult to establish tort: the courts have to consider the subjective mind rather than objective foreseeability, which leaves misfeasance at the latter end of the *ex post facto* accountability spectrum.[68] The tort of misfeasance is an alternative remedy to the tort of negligence specific to liability of public authorities, but this does not mean that public authorities are more likely to be inundated with a flood of claims because the courts will not simply accept misfeasance added to allegations of negligence.[69]

### 7.8.2 The Idea of Public Office

The tort of misfeasance is a wrong perpetrated by the an act or the omission of a public officer, and a 'public officer' is an individual acting in a public capacity. A

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[67] See generally *Yeun Kun Yeu* [1987] op. cit., n 59; *Johnson Matthey Plc v Arthur Young and The Governor of the Bank of England* [1989] 2 All ER 105; and *Davis v Percy Radcliffe* [1990] 1 WLR 821
[68] *R v Newham LBC, ex p Watkins* 9 (1994) 26 HLR 434

public officer is entrusted by statute with functions to be performed in the public interest or for public purposes.[70] According to Lawrence J in *Whittaker*, a public officer is an individual who discharges duties where the public has an interest and whose remuneration for such public services is drawn from public taxes.[71] This definition can include a broad range of functions and exposes a large body of persons to potential liability because of their public roles.[72] 'Public officer' includes: members of parliament, ministers,[73] judicial officers,[74] public servants[75] and police officers.[76] The concept of an 'office' is central to the definition and should be construed in a narrow sense and no one would deny that the public offices listed above can be captured quite easily by the definition.[77] According to Evans, public office should not be equated simply with employment by a public body. It must be distinguished on the basis of the public officer's responsibilities and duties and their elements of public trust and confidence.[78] The duration and remuneration are secondary concerns in the nature of the office.[79] A private body can also be deemed a public office providing a public function. For example, the Takeovers and Mergers Panel performs a public function.[80] An individual public officer's act or omission can be construed as vicarious liability of misfeasance. As the decision in *Racz*[81] showed, the acts or omissions of prison officers can lead to the Home Office being held liable as their employer.

In order to establish whether a party to an action holds a public office, the officer or office must essentially perform duties which are in the public interest. The Bank, a public corporation, undertook a number of *de facto* and *de jure* public duties as the Central Bank. In banking supervision the discretionary public responsibilities

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[69] *Lam v Brennan* [1997] 3 PLR 22
[70] *Whitelegg v Richards* (1823) 2 B & C 45 and *Sutherland Shire Council v Heyman* (1985) 157 CLR 424
[71] *R v Whittaker* [1914] 3 K B 1283
[72] *Jones v Swansea City Council* [1989] 3 All ER 162
[73] *R v Boston* (1923) 33 C L R 386; *Smith v Christie* 55 D L R 68; and *Roncarelli v Duplessis* (1959) 16 D L R 2
[74] *R v Lord Bacon* (1620) 2 St Tr 1087
[75] *R v Clarke* [1954] A L R 312
[76] *Farrington v. Thompson* [1959] V R 286
[77] P D Finn, 'Public Officers: Some Personal Liabilities', Vol. 51, June, *Australian Law Journal*, (1977) 313-318
[78] *Ex parte Kearney* (1917) 17 S R (N S W) 578
[79] *Jones v Swansea City Council* [1990] 1 WLR 54
[80] *R v Panel of Takeovers and Mergers, ex p. Datafin plc* (1987) QB 815
[81] *Racz v Home Office* [1994] 1 All ER 97

derived from the Banking Act 1979 and the Banking Act 1987. According to s.1(4) of the Banking Act 1987, the Bank, members of its court of directors and officers or servant all have a responsibility to discharge functions that derive from the Acts. Their discretionary public functions are in general terms, to supervise authorised institutions in the interest of depositors. Case law determines that 'public office' exists when functions are discharged with the public in mind. It would be reasonable to assert, therefore, that the Bank and/or its officers can, for the purposes of misfeasance in public, be construed to be in public office and deemed to be the directing mind of regulation and supervision.[82] The allegations point to specific individuals within the banking supervision division. This in many respects follows the joint opinion in *Mengel*[83] which suggests that misfeasance is based on the act or omission of public officers in their personal capacity.

### 7.8.3 The Evolution of the Two Limbs of Misfeasance in Public Office

The tort of misfeasance in public office has a very long history with its roots dating back to 1364[84] where some of the early decisions may have overlapped with actions relating to deceit and negligence. Its popularity grew in the nineteenth century with the decision in *David v Abdul Cader*.[85] Many of the old cases centre on elections and the right to vote, judicial office or refusal of licence.[86] The old decisions had little impact on the *Three River Saga*, other than noting the confines of malice rather than two separate limbs[87]. According to Auld LJ (dissenting opinion) misfeasance applies to both acts and omissions and contrary to the view of Clarke J, there can be no policy justification for a dishonest failure to attempt to perform their responsibility even when it is in the best interest of the depositors.[88]

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[82] *Meridian Global Funds Management v Securities Commission* [1995] 2 AC 500
[83] *Northern Territories v Mengel* (1995) 69 ALJR 527 at p. 540
[84] R C Evans, 'Damages for Unlawful Administrative Action: The Remedy for Misfeasance in Public Office', Vol. 31, October, *International and Comparative Law Quarterly*, (1982) 640-660 at p. 640
[85] *David v Abdul Cader* [1963] 1 *WLR* 834
[86] R C Evans, (1982) op. cit., n. 84 at p. 643
[87] *Three Rivers DC v. Governor and Company of the Bank of England (No. 3)* [1996] 3 All ER 558 Clarke J referred to: *Turner v Sterling* (1671) 2 Vent 25; *Ashby v White* (1703) 2 Ld Raym 938; *Harman v Tappenden* (1801) 1 East 555; *Williams v Lewis* (1789) Peake Add Cas 157; *Cullen v Morris* (1819) 2 Stark 577; and *Tozer v Child* (1857) 7 E & B 377
[88] *Three Rivers DC v Governor of the Bank of England (CA)* [1999] 11 Admin LR 281 (Auld LJ dissenting opinion) at p. 423

### 7.8.3.1 Bourgoin

Particular reliance has been placed on the decision in *Bourgoin* because it argued that misfeasance in public office could be established in one of two ways without having to show malice.[89] The case concerned an action on the effect of a decision by the UK's Minister of Agriculture to revoke French turkey-producers' import licences, which stopped them from exporting to the UK. The plaintiffs brought an action for damages against the UK for loss of business, alleging that it was done to protect UK producers from foreign competition. The European Court of Justice held that for the purposes of the preliminary ruling, misfeasance in public office was established by the Minister and acknowledged that the revocation of the licence constitutes a breach of EC law and attracts compensation for damages. The court decided that where a person in public office performs an act that he knows he has no power to perform, misfeasance in public office can be evidenced as targeted-malice with the specific purpose of harming the target. The remit of the tort was clearly pointed out to be within the confines of actual knowledge of illegality and actual foresight of the loss ensuing from the act or omission of the public officer.

### 7.8.3.2 Mengel

The decision in *Mengel* examined what is deemed a 'well established action'. However, unlike *Bourgoin*, it deems that the constituent parts of duty of care, particularly 'foreseeability', are relevant in establishing that knowledge was a factor in an action or omission.[90] The joint conclusion in *Mengel* was criticised for blurring the nature of the tort with the suggestion that foreseeability of damage was not relevant.[91] The case related to the restrictions on the sale of cattle by inspectors of the Northern Territory Department of Primary Industries and Fisheries because of *brucellosis* and *tuberculosis* in the region. The *Mengel* claim was based on the losses incurred as a result of the restriction. The decision highlighted the strict remit of the tort where intentional harm is evidenced. Alternatively, the tort exists where recklessness on the part of the public officer is established in that he did not compute the harm that was to accrue as a result of his action or omission, or in that he was indifferent to the fact that harm would accrue.

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[89] *Bourgoin SA v Ministry of Agriculture Fisheries and Food* [1985] All ER 585
[90] *Mengel* (1995) op. cit., n. 83 at 527
[91] S Kneebone, 'Misfeasance in a Public Office after Mengel's Case: A 'Special' Tort no more?', July, *Tort Law Review*, (1996), 111-138

### 7.9 The Requisite State of Mind in Misfeasance

The underlying basis of the tort in this context is the abuse of public power; his is present in an alternative rather than one cumulative way, where the public officer's act or omission is underpinned by malice through 'spite or ill will', or where he public officer has knowledge that the act or omission is unlawful. The alternative ways are acknowledged in case law by their application.[92] The later cases recognise the two separate limbs of the tort,[93] and do not focus on a broad notion of malice alone.[94] The cases do not outline the nature of tort either exhaustively or consistently, particularly not the all-important degree of knowledge and foresight required in the second limb of establishing the existence of a tort.

Abuse of office is at the heart of misfeasance in public office which arises as some form of deliberate dishonesty or bad faith.[95] Best CJ, [96] said that the tort consisted of a public officer who 'abuses his office either by an act or omission the consequences of that is an injury to an individual'. The tort has, for example, been shown to be analogous with 'gross abuse of legal power', which is the antithesis of the proper use of power by a public officer.[97] The scope of the tort is uncertain because of the difficulty in defining its remit[98]. For example, the scope of misfeasance in public office is not confined to unlawful administrative acts because it includes elements of misuse of power, not only the invalidity of act or omission.[99] This distinguishes actions that constitute the tort of misfeasance from actions that constitute a tort of negligence and breach of statutory duty against public authorities. According to Clarke J, at first instance, the tort should not be equated with gross

[92] *Ashby* (1704) op. cit., n. 87 at 695
[93] *Three Rivers (No.3)* at p. 587
[94] *Garrett v Attorney General* [1997] 2 NZLR 332. See also the decision by Slade LJ recognition of the two limbs in: *Jones v. Swansea City Council* [1989] 3 All ER 162 at 173, whilst making reference to *Bourgoin* op. cit., n. 89. Further acceptance of the two limbs was made in *Gerrard v Manitiba* [1993] 1 WWR 182.
[95] *Elguzouli-Daf v Comr of Police of the Metropolis* [1995] QB 335
[96] *Henley v. Motor of Lyme* (1828) 5 Bing. 91. 107. Other cases are also cited as providing a wider ambit for liability, see: *Brasyer v Maclean* (1875) LR 6 PC which is supported by the later decision of *Farrington* [1959] op. cit., n 76 at p. 293, although the latter case is rejected in *Pemberton v Attorney-General* [1978] Tas SR, at 29, per Chambers J.
[97] *Roncarelli* (1959) op. cit., n. 73 *Rand J* at p. 706
[98] *Lord Jauncey* in *Racz* [1994] op. cit., n. 81, at p. 104
[99] *Jones* [1990] op. cit., n. 79; *Takaro Properties Ltd v Rowling* [1978] 2 NZLR 314; *Bourgoin* [1986] op. cit., n. 89; and *Mengel* (1995) op. cit., n. 83

negligence because in an action on misfeasance in public office the subjective state of mind has to be established.

The early decisions in the tort of misfeasance in public office recognised the different ways in which the tort could be established. Usually, malice was the essential component in the evidence of its existence. The old cases tend to focus on malice without clearly defining the term: In *Bromage*,[100] malice in fact and in law was distinguished in that malice in fact focused on ill will whereas malice in law focused on a wrongful act undertaken with an unjustifiable intention. The other decisions tended to focus on both facets of malice. According to *Harman*,[101] malice could be inferred from the conduct of the public officer, or, as in *Cullen*,[102] in some improper motive for an act. Clarke J, at first instance, concluded that the early decisions interpreted malice in a number of ways specific to the facts of the case,[103] which gave rise to a wide interpretation of malice, and without defining it, recognised that it subsists in the act or omission of the individual. This led Clarke J, at first instance, to conclude that malice is a wide enough concept to be interpretable not only as targeted malice or spite but also as wrongful acts done intentionally without just cause or excuse. Interestingly, in *Rawlinson*,[104] Barker J noted that malice descends into the realms of reckless indifference, thereby suggesting that it is not simply confined to the first limb of misfeasance. The wide interpretation of malice in case law legitimately encompasses the elements of the second limb of the tort because of the central idea of abuse of power. For example, in *Duplessis*,[105] the plaintiff's licence to sell alcohol, which was normally renewed annually, was cancelled because of his association with petty criminals whom he would bail if they were Jehovah's Witnesses. It was noted by *Rand J* that the public officer's statutory duties do not include a duty to cancel licences on the grounds on which he cancelled the licence in question. The act was deemed a gross abuse of statutory power intended to punish by destroying his livelihood.[106]

[100] *Bromage v Prosser* (1825) 4 B & C 247
[101] *Harman* (1801) op. cit., n. 87
[102] *Cullen* (1819) op. cit., n. 87
[103] *Bromage* (1825) *Bayley J* interpreted malice to "...means ill will against a person, but in its legal sense it means a wrongful act, done intentionally without just cause or excuse." op. cit., n. 100, at p. 254-255
[104] *Rawlinson v Rice* [1997] 2 NZLR 651
[105] *Farrington* [1959] op. cit., n. 76; and also *Roncarelli* [1959] op. cit., n. 73
[106] Ibid., *Ronarcelli* at p. 706.

The second category of the tort is clearly recognised but it is somewhat uncertain in terms of its constituent elements; the authorities have not clarified the mental elements of this second category. Like the first, the second limb consists of an act or omission which is an abuse and is deemed unlawful or invalid. Arguably, the second limb is not a distinct action but another manifestation of bad faith.[107] For Clarke J, the second limb of the tort was the central issue of the preliminary ruling at first instance in *Three Rivers* (No. 3). The existence of the second limb is re-affirmed by the earlier[108] and most recent decisions.[109] It is important to establish when knowledge is sufficient to constitute a tort of misfeasance[110] and whether liability can arise when persons simply know an act or omission to be beyond the powers of their office.[111] According to Lord Diplock, an act that knowingly exceeds the powers of an office can satisfy the second limb.[112] This was endorsed by the House of Lords decision in *Caveley* which accepted 'failure to establish reasonable cause'[113] as satisfactory. However, the decision in *Mengel* objected to the inclusion of 'constructive knowledge' in the duty of care concept,[114] thus placing the tort in a context of validity[115] broader than 'abuse of office'. The question of validity focuses on the conduct of the public officer rather than simply on the invalidity of the act or omission: It has to be established that the officer knew that the act in question was beyond his powers.[116] Occasionally, defendants in misfeasance actions do admit they knew their act was invalid or the evidence clearly suggests that knowledge existed.[117]

According to Clarke J, nothing less than actual knowledge or recklessness is sufficient. According to the opinions in *Mengel*, recklessness was regarded as sufficient for the first limb of the second category of the tort, where a public officer recklessly disregards the means of ascertaining the extent of his or her power.[118]

[107] P P Craig, (1999) op. cit., n. 4, at p. 878
[108] *Farrington*, [1959] op. cit., n. 76, at p. 293
[109] *Bourgoin* (1985), op. cit., n. 89; and *Mengel* (1995) op. cit., n. 83
[110] *Three Rivers (No.3)* [1996] op. cit., n. 87, at p. 569
[111] *Mengel* (1995) op. cit., n. 83, at p. 540
[112] *Dunlop v Woollahra Municipal Council* [1981] 1 All ER 1202
[113] *Calveley v Chief Constable of Merseyside* [1989] 1 All ER 1025
[114] *Mengel* (1995) op. cit., n. 83 at p. 541
[115] *Beaurain v Scott* (1813) 3 Camp. 388; and *Pickering v. James (1873) L R 8 C P 489*
[116] *Three Rivers (No. 3)* [1996] *Clarke J* placed particular reliance on *Mengel, Brennan J* op. cit., n. 83, at p. 546
[117] *Bourgoin* [1985] op. cit., n. 89; and earlier *Farrington* [1959] op. cit., n. 76
[118] *Mengel* (1995) op. cit., n. 83, *Brennan J* at p. 554 and *Deane J* p. 546 recognised the importance of reckless behaviour in public officers.

Clarke J placed particular reliance on Brennan J and Deane J, who had agreed that reckless indifference to the possibility of injury is sufficient. Clarke J further refined the difference between knowledge and recklessness by referring to *The Eurysthenes*.[119] According to Lord Denning, 'knowledge' consists not only being in the possession of positive knowledge but also instances of in which 'turning a blind eye' is apparent. If a suspicious man 'turns a blind eye' to the truth and refrains from inquiry so that he will not know it for certain, then he is to be regarded as knowing the truth. It appears, therefore, that 'turning a blind eye' is far more blameworthy than mere negligence. Negligence in not knowing the truth is not equivalent to avoiding knowledge of it. Lord Denning's 'turning a blind eye' essentially amounts to Peter Gibson J's 'wilfully shutting one's eye to the obvious' or 'wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make'.[120] Clarke J used these concepts to underpin his own views about state of mind and suggested that recklessness in the subjective sense is sufficient.

The Court of Appeal accepted the delineation of knowledge by Clarke J.[121] The Court of Appeal placed particular emphasis on the importance of dishonesty that emanates from breach of fiduciary duty, and effectively narrowed the remit of the tort to become even tighter than the traditional ones. The Court of Appeal accepted Clarke J's interpretation of the second limb of the tort but placed emphasis on the notion of dishonesty, thereby introducing an additional criteria into the equation for determining the form and sufficiency of 'knowledge'.[122] The idea of dishonesty, according to Hirst LJ and Walker LJ, informs and permeates the ingredients of the tort,[123] equating it to the idea of abuse in the tort. Following Millet J, the view of Peter Gibson J[124] that the relevant distinctions in the concept 'knowledge' are 'honesty' and 'dishonesty' was considered over-elaborate. This point was reiterated by Lord

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[119] *Three Rivers (No. 3)* [1996] op. cit., n. 87 at pp. 579; particular reference is made to: *Cia Maritima San Basilio SA v. Oceana Mutual Underwriting Association (Bermuda) Ltd* [1976] 3 All ER 243 at p. 251

[120] *Societe Generale pour Favouiser le Developpment du Commerce et de l' Industrien France SA* [1992] 4 All ER 161 at p. 235

[121] *Three Rivers (CA)* [1999] op. cit., n. 88, at p. 324. *R v Chief Constable of North Wales Police, ex p AB* 3 WLR 724; *Barnard v Restormel Borough Council* 6 February 1998 (unreported); Elloitt v Chief Constable of Wiltshire 20 November 1996 (unreported) etc. It is important to note these decisions simply follow the opinion of Clarke J rather than take his conclusions to task.

[122] *Mengel* (1995) op. cit., n. 83, at p.185; see also *Garrett v A-G* [1997] 2 NZLR 332; and *Rawlinson v Rice* [1997] 2 NZLR 651

[123] *Three Rivers* CA (1999) op. cit., n. 88, at p. 334

Nicholls, who proposed that acts of dishonesty should be distinguished from acts of negligence, and that 'knowingly' was required as a description of acts or omissions in that 'darker spectrum' of public office where misfeasance must surely reside. In the light of the concern expressed by Millet J and Lord Nicholls, the Court of Appeal added 'dishonesty' to the equation of knowledge.[125] According to Auld LJ (dissenting opinion), dishonesty is 'something more which distinguishes it from other forms of civil wrong and prevents the tort from overflowing its banks'.[126] According to Auld LJ, the tort should be simply established by proving that the public officer disregards his duties or does not honestly perform his duties without recognising the perils.[127]

Misfeasance also requires consideration of whether damage needs to be foreseeable or foreseen. This is crucial in determining that the necessary 'state of mind' was present, which in turn is crucial in evaluating the facts, in the light of that standard, to determine whether the tort of misfeasance is an extension of the tort of negligence. The ultimate question for consideration is whether foreseeability of harm is appropriate in this context. An important point to bear in mind is that foreseeability of harm in its own right does not necessarily mean that an action in negligence will succeed; a number of safety nets to curtail a duty of care need to be overcome.[128] According to Watkin J,[129] foreseeability is simply the first condition to establish the courts have to take into account other factors in the loss or damage claim, including the nature of the event or act and more importantly matters of public policy.

The issue of damage being foreseen or foreseeable in a quest to establish misfeasance was in an uncertain state before Clarke J's emphasis on actual foresight placed it on a much clearer footing, though for Auld LJ that was stil an insecure one.[130] Clarke J was of the view that the basis of the tort should be more stringent than merely the knowledge that an act was unlawful. He proposed that liability should be more 'closely confined' to include 'acts which are calculated in the ordinary course to

[124] *Agip (Africa) v Jackson* [1990] Ch 265
[125] *Three Rivers* CA (1999) op. cit., n. 88, at p. 334
[126] *Three Rivers* CA (1999) op. cit., n. 88, at p. 440
[127] *Three Rivers* CA (1999) op. cit., n. 88, at p. 440
[128] *Dorset Yacht Co v Home Office* [1970] AC 1004 at p.1030
[129] *Lamb v Camden London Borough Council* [1981] 1 QB 625 at p. 642
[130] *Three Rivers* CA (1999) op. cit., n. 88 at p. 442

cause harm…or with reckless indifference to the harm that is likely to ensue'.[131] Clarke J rejected the interpretation in *Bourgoin* by Mann J,[132] and was of the view that knowledge that an act is invalid, coupled with foresight that its commission would probably cause damage to the plaintiff is enough. This conclusion follows Brennan J in *Mengel* who stated that 'causation of damage is relevant; foreseeability of damage is not'.[133] This is notwithstanding the fact the majority decision in *Mengel* thought foresight of harm was sufficient but not in terms of establishing knowledge. Clarke J recognised that there was no support in his conclusion for the opinion that reasonable foresight is sufficient at the second stage.[134] The inclusion of 'foresight of harm' is a logical extension of how knowledge is established: It is now actual knowledge positive state of mind, or a recklessness with advertence to consequences as distinct from inadvertence to consequence, which constitutes negligence.[135] This is also the reasoning of *Lord Steyn* because it provides a remedy against executive and administrative abuse of power without exposing public officers who act in good faith to 'unmeritorious actions'.[136]

**7.10 Duty to the Depositors**

Departing from the opinion of Clarke J at first instance, the Court of Appeal added an additional hurdle for future plaintiffs to overcome by introducing a requirement of sufficient proximity between the defendant and plaintiff as a pre-condition for establishing misfeasance.[137] It is crucial to determine whether 'proximity' is necessary to establish the tort of misfeasance in public office to determine whether it is distinct from the tort of negligence. Proximity is deemed 'elusive',[138] but generally exists where 'the directness and closeness of the relationship between the parties [is] very apparent'.[139] Policy grounds, in the disguise of proximity, are used to curtail the existence of duty to take reasonable care to avoid

131 *Three Rivers (No. 3)* [1996] op. cit., n. 87, at p. 540
132 *Bourgoin* (1985) op. cit., n. 89, at p. 602
133 *Mengel* (1995) op. cit., n. 83, at p. 547
134 *Three Rivers (No. 3)* [1996] at p. 578
135 S Kneebone, (1996) op. cit., n. 91, at p. 135 referring to: P Cane, "Justice and Justifications for Tort Liability", Vol. 2, *Oxford Journal of Legal Studies*, (1982)
136 *Three Rivers* HL [2000] op. cit., n. 55, at p. 12
137 *Three Rivers* CA [1999] op. cit., n. 88, at p. 342
138 *Murphy v Brentwood District Council* [1991] 1 AC 398 at p. 471
139 *Yuen Kun Yeu* [1987] op. cit., n. 59, at p. 192

loss or damage,[140] particularly in cases of economic loss, in order to prevent claims by an unascertainable class of individuals.[141] This effectively limits the existence of a duty of care and prevents a flood of claims against regulators.

According to Clarke J, at first instance the above policy-considerations were necessary to curtail the scope of the duty-of-care in an action in the tort of negligence but not in a case involving an allegation of misfeasance. The hurdle to establish deliberate abuse of power through either of the two limbs has the effect of protecting a regulator against over-zealous plaintiffs.[142] It is submitted that the House of Lords was right in following this line of argument and did correctly, in the author's opinion, distinguish misfeasance from the tort of negligence. Their Lordships established that the hurdle needed to satisfy the requisite state of mind and to determine loss would probably ensue, providing the appropriate safety mechanisms to rein in the unique tort.[143]

### 7.11 (Part Two) Causation and Misfeasance in Public Office

The question of causation and the remoteness of damage are crucial to establish misfeasance. This requires consideration of the degree to which the relevant facts fulfil the allegations, which is a concern more appropriate for a trial judge to determine, and whether the loss was caused by the defendant's act or omission or whether it was too remote. On common-sense principles,[144] an act or omission must provide more than just the occasion or opportunity to sustain loss,[145] particularly when regulatory decisions have a wide discretionary authority that make the ascertaining of causation problematic.[146] The issue here is whether the Bank's alleged misfeasance was an effective and direct cause of the ensuing loss, or whether it merely provided the occasion for the loss because it did not have day-to-day control of BCCI and its

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140 *Governors of Peabody Donation Fund v Sir Lindsay Parkinson & Co Ltd* [1985] A C 210 at p. 240-241

141 *Yeun Kun Yeu* [1987] op. cit., n. 59, at p. 196 and *Davis* [1990] op. cit., n. 67, at p. 827

142 *Three Rivers (No. 3)* [1996] op. cit., n. 87, at p. 584

143 *Three Rivers* HL [2000] op. cit., n. 55, at p. 10

144 *Cork v. Kirby Maclean Ltd* [1952] 2 All ER 402 at p. 406-407. This is notwithstanding the fact that the "But For Test" has limitations where there are multiple causations.

145 *Galoo Ltd (in liq) v Bright Grahame Murray (a firm)* [1995] 1 All ER 16 Glidewell LJ at pp. 16-19

146 J McBride, 'Remedy for Unlawful Administrative Action', Vol. 38, No. 2, *Cambridge Law Journal*, (1979) 323-345 at p. 334

activities.[147] Allegations of misfeasance require a full trial rather than at a preliminary hearing to determine whether the facts could satisfy the requirements elaborated on in Part One.

### 7.11.1 The Bingham Report

The crucial piece of evidence in the *Three Rivers* saga is the Bingham Report.[148] The Inquiry highlights the long history of BCCI, in particular, the relationship between the Bank and BCCI. The terms of reference of the Inquiry were:

- What did the United Kingdom authorities know at all relevant times?
- Should they have known more?
- What action did the United Kingdom authorities take in relation to *BCCI* at all relevant times?
- Should they have acted differently?
- What should be done to prevent, or minimise the risk of, such an event recurring in the future? [149]

The House of Lords' decision questioned the reliance placed on the Bingham Report by Clarke J and the Court of Appeal, thereby calling into question the usefulness of the Report: on the one hand they held the Report to be of limited value, and on the other, they were relying on its findings to determine whether the case should be struck-out.[150] Their decision supported the dissenting opinion of Auld LJ, who questioned the right to treat the Bingham Report as effectively conclusive.[151] According to Lord Hobhouse, the critical issue was whether to rely on the Bingham Report or dismiss its decision, not on whether one agrees with it.[152] While both Bingham LJ and Clarke J are critical of the Bank's conduct, both are reticent about considering the Bank liable for the failures in its supervision of BCCI.[153] Clarke J's initial conclusion, like Bingham LJ's, blames the collapse and losses incurred by

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147 *Three Rivers (No. 3)* [1996] op. cit., n. 87, at pp. 628-629

148 *Inquiry into the Supervision of the Bank of Credit and Commerce International by the Right Honourable Lord Bingham*, London, HMSO July 1992

149 Ibid.,

150 *Three Rivers* HL [2001] op. cit., 54 at p. 524 supporting the opinion of Auld LJ (dissenting)

151 *Three Rivers* HL [2001] op. cit., 54 at p. 524

152 *Three Rivers* HL [2001] op. cit., 54 at p. 571

153 Unreported decision: *Three Rivers DC v Bank of England* QB 1993 Folio No. 1309, 30th July 1997 at p. 40

depositors and creditors on BCCI alone, because of its 'systemic fraud'. The Lords' majority decision calls into question the opinion of Clarke J that the Report's terms of reference require an investigation into the Bank's knowledge of the BCCI affair. The Lords suggested that the plaintiffs must obtain the evidence that underpins Bingham LJ's findings. It is very important to review whether the Bank of England is negligent in the BCCI saga.

The Inquiry into the BCCI affair could not be equated with the type of investigation that would ensue from a civil trial into the issues arising from the BCCI affair. The Report by Bingham LJ was not a full public inquiry under the Tribunals and Inquiry Act 1921 but an inquiry arranged voluntarily by the Bank, and His Lordship had no power to compel the attendance of witnesses.[154] It is submitted that Clarke J and the Court of Appeal placed too much emphasis on the Report in determining whether the case should be struck out. On the other hand, there was no other report or evidence before the court.

### 7.11.2 The Preliminary Conclusions

The complexity of the case is shown by the chronological evidence provided by the Bingham Report about the Bank's responsibilities as a third party for the losses. Lord Hobhouse estimated that the trial would last for a year at least and, being a case without real prospect of success, it would use a disproportionate amount of resources and court time.[155] Their Lordships suggested that the appropriate test to determine whether the case should be struck out is not whether the case is bound to fail but whether the case has any 'real prospect of success'.[156] The Lords were at pains to make clear that the question of whether the case should be struck out does not necessarily mean that the allegations are not proven. Their Lordship's decision called into question Clarke J's conclusion that the case is bound to fail because there is little likelihood of further evidence becoming available to the plaintiffs in support of their claims.[157] Therefore, on this basis, it was accepted that the claim should proceed on a purely objective basis and without any pre-conditions regarding the outcome of the

[154] *Price Waterhouse v BCCI Holdings* [1992] BCLC 583
[155] *Three Rivers* HL [2001] op. cit., n. 54, Lord Hobhouse of Woodborough (dissenting) at p. 565
[156] *Three Rivers* HL [2001] op. cit., n. 54, at p. 542
[157] *Three Rivers* HL [2001] op. cit., n. 54, at p. 562

case. The unreported *Three Rivers*[158] decision left more unanswered questions, which led to the conclusion that a full trial is the only route for getting to the bottom of the BCCI affair. This decision was made after consideration of the numerous issues raised by the Bingham Report, which calls into question the basis of the decision.[159] According to Lord Hope, not all of the allegations could simply be struck out, and it would be unreasonable to strike out the whole claim.

The appeal examined the substantive claim of the plaintiffs' allegations, in particular, the question of causation, focusing on the second limb of the tort of misfeasance. Clarke J's, initial conclusion was that the plaintiffs could establish that the Bank knew, believed or suspected at each stage that its proposed act or its omission was unlawful, especially in its application of s.3(5) of the Banking Act 1979. This was endorsed by the Court of Appeal. Clarke J considered chronologically a number of allegations including: the original granting of licence to the divestment by Bank of America, the continuing supervision of BCCI, and the issues surrounding the re-location of Central Treasury operations, which happened in the period preceding its closure. On the basis of these allegations, Clarke J had to determine whether the Bank knew, believed or suspected that BCCI would collapse, that a rescue package would not be secured, and that losses to potential and future depositors would occur. Clarke J held the Bank had no case to answer. It had not dishonestly granted a licence to BCCI, nor or should it have revoked its licence or authorisation once it knew, believed or suspected that BCCI would collapse. It is to be noted, however, that at first instance and in the Court of Appeal it was recognised that that in some circumstances the supervision had been ineffective. However, the Court of Appeal agreed with Clarke J that the claimants could not establish that the Bank actually knew BCCI would probably collapse or that it would not be rescued. Serious issues in respect of the probity of BCCI reveal a picture which was far worse than even the most sceptical critic could have suspected.[160] While the earlier decisions focus on the knowledge of probable collapse and consequential loss, the House of Lords placed more emphasis on foresight, i.e. recklessness in the disregard of the probable collapse and consequential loss. The *Three Rivers* saga highlights the

[158] Three Rivers [1997] op. cit., n. 156

[159] For coverage of the unreported decision see, D Singh, 'Misfeasance in public office: the case of Banking Supervision and BCCI', Vol. 6, No. 4, *European Financial Services Law*, (1999) 128-135

reluctance to declare regulators liable, and an inclination for recourse to the implied immunity arguments in the tort of negligence to justify the narrowing of the tort of misfeasance in public office. In the strict sense, the arguments against liability in an action of tort of negligence curtail the objective basis of foreseeability and proximity of the loss or damage.

### 7.12 (Part Three) Liability under Community Law

The above analysis of parliamentary and legal accountability has considered that private law rights in the domestic context are private-law rights conferred by Community law.[161] Community law becomes ever more important in the quest to enforce private-law rights against public authorities when those rights are curtailed in a domestic context by courts that uphold the implied immunity of public authorities.[162] Following on from this restrictive approach, the specific remedy unique to public authorities, misfeasance in public office makes it generally difficult to claim damages for abuse of public office.[163] Therefore, crucial to the protection of private rights is the important question of remedies, such as reparations for the damage caused by the act or omission of a regulatory body in breach of Community law. This section will analyse the remedies available in Community law to address alleged wrongs against depositors. The plaintiffs alleged that the Bank 'flagrantly and/or seriously and/or repeatedly violated' the terms of the First Banking Directive[164] in regards to supervision (incorporated in domestic law by the Banking Act 1979 and the Banking Act 1987) by giving a licence to BCCI and continuously supervising its activities.

### 7.12.1 The Remedy of State Liability

Traditionally, Community law protected private-law rights by placing the onus of providing remedies squarely on the shoulders of the Member State, even though

[160] *Three Rivers* CA [1999] op. cit., n. 88 at p. 368

[161] Case 26/62 *NV. Algemene Transporten Expedite Onderneming van Gend en Loos v. Nederlandse Administratie der Belastingen* [1963] ECR 1; Case 6/64 *Flaminio Costa v ENEL* [1964] ECR 585

[162] R Caranta, 'Governmental Liability After Francovich', Vol. 52, No. 2, *Cambridge Law Journal*, (1993), 272-297

[163] *Brasserie du Pecheur SA v. Germany* (Case C-46/93) 1996 1 CMLR 889 at para. 73

[164] First Council Directive of 12 December 1977 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (77/780/EEC) (OJ 1977 L322 p. 30

they were under no obligation to create new remedies to protect individual rights.[165] Notwithstanding this fact, the Court of Justice moved away from this approach towards emphasising the importance of devising remedies to enforce private-law rights under Community law. According to Article 5, Member States are responsible for taking all appropriate measures to fulfil their obligations under Community law.[166] This Article voices the desire to have appropriate and enforceable sanctions and remedies applicable in domestic claims, and requires English courts to adapt to Community law[167] in order to ensure its 'effectiveness'.[168] The latter decision in *Factortame I* showed that where a domestic remedy does not exist the courts have to look to Community law.

State liability is a key remedy added by the Court of Justice to ensure the 'effectiveness' of Community law when a breach of Community law results in loss or damage to those endowed with Community rights. The conditions of success in establishing state liability are broad and result from the landmark decision of *Francovich*,[169] followed by *Brasserie du Pecheur*.[170] *Francovich* provided the preliminary conditions for establishing state liability, and asserted that the directive in question confers clearly identifiable rights on individuals, and that a causal link has to exist between the breach of those rights and the injury suffered.[171] The decision in *Brasserie* built on the rudimentary conditions of state liability and answered the questions left open by *Francovich*. The case showed that there should be remedy for a much broader range of breaches of Community law, not just for breach arising from the non-implementation of a directive. The decision placed the conditions into the broad context of the EC Treaty, thus fusing state liability (*Francovich* style) with Community liability under the umbrella of Article 215 (non-contractual liability).

[165] Case 33/76 *Rewe-Zentralfinanz v Landwirtschaftskammer fur das Saarland* [1976] ECR 1989 and, in particular, Case 158/80 *Rewe v Hauptzollamt Kiel* [1981] ECR 1805
[166] Article 5 of the EEC Treaty (now Article 10)
[167] *Factorame Ltd v Secretary of State for Transport (No. 2)* [1991] AC 603
[168] Case 213/89 *R v Secretary of State for Transport ex p Factorame* [1990] 3 CMLR 1; and Case 271/91 *Marshall v Southampton and South West Area Health Authority (No. 2)* [1993] 3 CMLR 293.
[169] C-6/90 and C-9/90 *Francovich v Italy Joined* [1991] ECR I-5357. This case related to *Council Directive 80/987 on the approximation of laws of member states relating to the protection of employees in the event of the insolvency of their employee* (O J 1980 L283) p. 23
[170] Brasserie du Pecheur SA v. Germany (Case C-46/93) 1996 1 CMLR 889. This case related to a breach of Article 30 of the Treaty of Rome (now Article 28)
[171] *Francovich*, op. cit., n. 169 at para, 40

The decision re-affirmed the principle and the conditions highlighted by *Francovich* and provided reparation for loss or damage to individuals caused by a breach of Community law. Included in the equation to determine whether liability exists is the importance of considering whether the relevant piece of Community legislation provides a wide margin of discretion, and if so, whether the breach is sufficiently serious. Seriousness of the breach is determined by whether the State had 'manifestly and gravely disregarded' the limits of its discretion. The decision also highlights a number of other factors a court may consider when determining whether liability exists. For example, the clarity and precision of the ruled breached; the degree of residual discretion within the rule; whether the rule violated and the loss or injury caused was intentional or involuntary; whether the error in law was excusable; whether the loss or damage is attributable from the particular stance taken by the Community institution; whether the particular policy-line is contrary to Community law; whether the breach was persistent.[172]

### 7.12.2 The Purpose of the First Banking Directive

The First Banking Directive 1977 emanates from Article 52-58 and 59-66 of the Treaty, which abolished restrictions on the right of establishment and the freedom to provide services. The directive was the initial process of harmonisation of banking regulation and supervision in the European Community and attempted to co-ordinate the minimum standards of banking regulations In the Member States. The process of harmonising banking regulation under Art 57 (2) of the Treaty required unanimity inside the Council, which indicates the sensitivity surrounding of the process. There was little progress until the Single Market Programme. In many respects, the sensitivity, at that time, resulted from the disparity between the styles of banking regulation and supervision of the Member States. For example, the UK approach was far less restrictive than many other styles of regulation in the Community. The First Banking Directive 1977 was the initial broad expression of intent and was fragmented as specific directives relating to prudential standards as part of the Single Market Programme. They were: the Second Banking Directive, Investment Services

[172] Brasserie (1996) op. cit., n. 169 at para, 56

Directive, Solvency Ratio, Own Funds and Capital Adequacy Directives (CAD II, CAD III).[173]

The First Banking Directive took a broad normative approach and gave the competent authority the discretion to interpret the recitals and the articles in the overall spirit rather than attempt to achieve mirror-image harmonisation across all the Member States. This is notwithstanding the fact that one of the aims of the directive was to reduce the discretion Member states have in authorising credit institutions. The first recital provides the backdrop to the purpose of the directive, which is to prohibit discrimination on national grounds against credit institutions, and to dismantle the 'most obstructive differences' among these institutions.[174] The Directive did not underestimate the task of co-ordinating the laws to allow credit institutions the freedom to establish or provide services in the Community. It is obvious that further measures are required to create a common market for credit institutions[175] in which savings are protected and conditions standardised sufficiently to enable competition on equal terms among institutions, and to ensure that there is a framework of prudential regulations incumbent upon all institutions that receive repayable funds from the public.[176]

Moreover, the recitals refer to the importance of protecting savers and of creating the appropriate conditions for competition to flourish in the community. The directive provides broad standards for the safety of the deposit-taking business as defined by the directive. However, the UK went further and introduced the Deposit Protection Scheme under the Banking Act 1979. The other recitals provide specific prudential measures to be assessed by competent authorities so that credit institutions within the European Community conform to particular minimum standards of capital adequacy, solvency, and liquidity. The articles, which elaborate on the recitals, provide the purpose for the directive and only give a broad outline of what the EC expect of competent authorities in terms of regulation and supervision of credit institutions like BCCI.

173 For a discussion of the development of prudential regulation and supervision of banks see Chapter 3 Legal Aspects of Prudential Supervision
174 *First Banking Directive* [1977] op. cit., 164, at *recital* 1 & 2
175 *First Banking Directive* [1977] op. cit., 164, at *recital* 3 & 8
176 *First Banking Directive* [1977] op. cit., 164, at *recital* 4 & 5

The directive focuses on 'credit institutions'[177] that take up and pursue the business of a credit institution.[178] These institutions are required to obtain authorisation before commencing business.[179] Article 3 outlines the authorisation. They are: separate and 'adequate' own funds, observance of the principle of 'four eyes', good reputation and experience. The directive does not abolish prior regulation or supervision of banking business. Member states are to have in place an administrative mechanism for authorisation-procedures to prohibit illegal deposit-taking by introducing a licensing system,[180] and more importantly, the power to withdraw authorisation that Member States can expand upon.[181] It also requires that prudential regulation be in place and observed by credit institutions 'which may serve to ensure that savings are protected'.[182] This article, which seems on the face of it to provide for the safety of depositors, recognises that prudential regulation 'may only serve' to protect savings. It is clear that such regulation does not definitely safeguard savings, and that regulation serves only a limited purpose. Moreover, the article is couched in terms of co-ordination rather than safety of savings. Other provisions build on the notion of co-ordination by stipulating that Member states 'shall' co-operate in terms of supervising credit institutions.[183] This underlying purpose has been re-affirmed in the various decisions of the Court of Justice, nowhere more than in the decision in *Parodi* that declared the purpose of the directive to be the initial act in the process of harmonising minimum standards of authorisation.[184] The opinion in *ECOSOC* also refers to the need to develop measures to achieve harmonisation through the protection of depositor interests.

The question of whether the directive confers enforceable rights on the depositors is somewhat problematic. It is clear that the directive does identify particular duties in its statement of principles and powers with regard to co-ordination of banking regulation and supervision and the safety of depositors. For Clarke J at first instance the immediate purpose of the directive was harmonisation of which the

177 *First Banking Directive* [1977] op. cit., 164, at Title I Definitions and scope, Article 1
178 *First Banking Directive* [1977] op. cit., 164, at Article 2
179 *First Banking Directive* [1977] op. cit., 164, at Title II Article 3
180 *First Banking Directive* [1977] op. cit., 164, at Article 3
181 *First Banking Directive* [1977] op. cit., 164, at Article 8
182 *First Banking Directive* [1977] op. cit., 164, at Article 6 (1)
183 *First Banking Directive* [1977] op. cit., 164, at Article 7
184 Case C-222/95 *Societe Civile Immobiliere Parodi v Banque H Albert de Bary et Cie* [1997] ECR I-3899; see also Case C –366/97 *Romanelli (Criminal Proceedings against)* [1999] ECR I-855

key requirement is the protection of depositor interests.[185] Clarke J noted that safety of depositors is a purpose of banking regulation in most states, and this requires the banking regulator to balance that interest with the conflicting interest of serving the wider public good. This conclusion is supported by the opinion of Hirst LJ and Robert Walker LJ in the Court of Appeal decision. The plaintiffs were thus given to understand that since the purpose of the directive is the protection of depositors interests, it does confer rights that the depositors of BCCI can enforce. This general conclusion is not endorsed by Auld LJ, who held that the overall purpose of the directive is to co-ordinate technical laws to ensure that 'savings are protected' and is not just a corollary to harmonisation. Lord Hope in the House of Lords endorsed Clarke J's initial conclusions that it was not a purpose of the directive to promote or protect individual depositors.[186]

### 7.12.3 Becker Type-Liability/Francovich Type-Liability

Effectiveness of Community law is essentially based on the obligation of the Member State to ensure EC legislation is appropriately incorporated into domestic law to confer enforceable rights. The House of Lords draws specific similarities between the remedy of direct-effect and state liability, particularly the rule that the provision of the directive is 'unconditional and sufficiently precise'[187] to identify the persons who qualify for protection, the nature of the protection, and the identity of the persons obliged to provide protection. In terms of European Community Law, the first method of attributing liability is described in *Becker*. This and the other descriptions of methods of attributing liability, because they are couched in broad terms, leave the precise determination of the methods to the Member States. The plaintiffs have to satisfy the principle outlined in *Becker*:

> "*... provisions of a directive...as far as their subject-matter is concerned, to be unconditional and sufficiently precise...be relied upon as against any national provision which is incompatible...in so far as the provisions define rights which the individuals are able to assert against the state.*"

Whilst banking regulation and supervision are expressed in terms of specific requirements, the provisions discussed above are rightly not construed as being clear

185 *Three Rivers* HL [2000] op. cit., n. 55, at p. 19
186 *Three Rivers* HL [2000] op. cit., n. 55, at p. 23
187 *Three Rivers* HL [2000] op. cit., n. 55, at p. 15

and certain in the sense of the *Becker* principle. Even though the safety of savers is clearly provided for, it does not confer express rights on depositors that can be exercised against the regulator. However, Auld LJ attempts to interpret the principle more broadly by suggesting the directive does confer particular duties on the competent authority. This view was rejected by the House of Lords. This would effectively mean that banking regulation conferred particular rights against a regulator because the general purpose of such regulation is safety of depositors. This point is contrary to the decision in *R v International Stock Exchange*, where listing rules did not confer rights on investors in terms of their safety, even though it was a general purpose of the directive.[188]

The principles to establish liability focus on the infringed community right and whether it confers directly enforceable rights of which the breach is sufficiently serious. The loss or damage sustained by the individual needs to have been caused by the breach of obligation imposed by Community Law. In order to aid the interpretation of these principles, the court need to consider the clarity and precision of the rule and the degree of discretion it gives the Member state in implementing the it, and whether the loss or damage in question was intentional or involuntary. The directive has the dual purpose of protecting depositors and co-ordinating regulation and supervision in the community, the former being the justification of harmonised laws. Though the first directive does appear to attribute responsibility to the Bank, its language is general and open to interpretation. This is notwithstanding the fact that ensuring the enforceability of Community rights can on occasion mean also that the competent authority is required to implement administrative systems to ensure proper implementation rather than simply incorporate it into domestic legislation.[189] The efforts to co-ordinate supervision of the activities of credit institutions in Member States override the general duty in terms of safeguarding depositor interests.

### 7.13 Conclusion

Parliament is the key advocate of ensuring that regulatory bodies are accountable to the wider public. The process of accountability does legitimate the

[188] *R v International Stock Exchange of the UK and the Republic of Ireland ex p Else* [1993] All ER 420
[189] Case C-127/95 *Norbrook Labatories Ltd v Ministry of Agriculture, Fisheries and Food* [1998] ECR I-1513

discretion-based approach as the most appropriate way of exercising powers. In many respects the discretion-based approach did come under intense pressure, resulting in operational changes.

The forms of accountability outlined above are concerned with the collective good or public interest. Individual cases are not completely ignored but investigated through alternative forms of accountability. This is because the parliamentary accountability-process essentially seeks explanation rather than attempts to resolve individual problems that arise from mis-regulation. The creation of the Consumer Panel would mean that consumer interests have an appropriate platform for rational input into policy formation, thus opening up the regulatory regime for formal consultation with consumer interests in mind. However, it is unlikely that the Consumer Panel will have the same input into policy formation as, for example, the Practitioner Panel.

Parliament provides these mechanisms for the resolution of consumer concerns a regulatory framework that is independent of the courts. The FOS provides the platform to deal with such issues. It is these forms of accountability, and the compensation-measures incorporated in a regulatory regime, that the courts have called the 'alternative forms of compensation and remedy' in judicial reviews and during tort-of-negligence hearings.

The establishment of the Independent Complaints Commissioner provides more accountability, which means that the FSA will be highly accountable as a regulator. The proposal to expose the FSA to audit by the National Audit Office would, in many respects, increase accountability because it would mean that the regulatory order is open to independent assessment of whether it is an effective regulator of regulating of the financial markets. The proposal of a 'value for money' audit provides a step in this direction, but the NAO would have provided a much wider assessment.

The *prima facie* evidence from the action in misfeasance in public office, suggests that the Bank mis-handled the supervision of BCCI. However, the implied immunity from liability for negligence and the expressed immunity conferred by the

Banking Act 1987 prevent charges being brought against the Bank on allegations of negligence. The success of having a full trial no way means the action will go in the plaintiffs' favour. This is because in the case of misfeasance the evidentiary burden of establishing actual foresight is great, a consequence of the fact that an abuse of power is central to the tort which, in its own right, would be very difficult to establish. Though a major concern of the Bank is safeguarding the interests of depositors, that is not to ensure their safety: to ensure their safety would be to guarantee that their deposits are secure. This would be a great regulatory burden and would undermine the essential component of banking, namely, risk. Furthermore, the establishment of the Depositor Protection Scheme, under the Unified Compensation Scheme, gives the depositors a limited guarantee in that plaintiffs will be compensated if they are eligible on an objective of torts *per se*. The question of whether that is sufficient is essentially political, not regulatory.

In the case of public bodies such as the Bank and the FSA, the responsibilities they have are underpinned by a number of policy concerns about ensuring financial stability. This was the key concern of the Bank and it manifests itself in many ways such as ensuring monetary stability and openness (competition), but also relates to safeguarding the financial system and its participants. The transfer of banking supervision to a single regulator could ensure a relatively new objective for banking supervision and regulation, one in which the focus moves away from financial stability towards consumer protection. The attainment of this objective will be a yardstick for measuring the performance of the FSA.

## Conclusions

The regulation and supervision of banking institutions is a complex affair involving statutory rules, principles and guidance. The focus of this thesis has been on the limits rather than the effectiveness of regulation and supervision. It has attempted to expound on primary sources of information with secondary sources of an inter-disciplinary nature to analyse the relationship between the regulator, auditor and banker and to note that legislation alone cannot ensure co-operation, honesty and trust.

The epoch for change that brought to the fore the vulnerability of the financial system and markets was the secondary banking crisis that resulted from unregulated activities. That experience made it necessary to avert serious damage by providing support through the Lender of Last Resort (LOLR) function. The episode showed the unique position and vulnerability of unregulated risk-taking. Furthermore, it showed that concerted efforts and resources are needed to avert disaster. The importance of *ex ante* regulation and supervision in avoiding market disruption is clear. This episode proved that in the modern era of regulation and supervision there are a number of reasons for the regulation and supervision of banking institutions: The interdependency of the financial markets and the concerted effort needed to manage the financial fall-out of bank failure.

Formalised regulation and supervision, as distinct from rudimentary control by monetary-policy measures, came into being with the Banking Act 1979. This Act built on the monetary-returns system for managing government finance and used it, for the purpose of prudential returns, to monitor and measure capital and risks. It introduced the Deposit Insurance Scheme (DIS) to prevent loss of depositors' money when deposit-taking authorised institutions' risk-management systems fail. Paradoxically, though the Banking Act 1979 initiated formalism, the Bank continued to advocate an anti-formalistic approach. The rules it advocated required the use of judgment to determine the appropriate way they should be applied.

The Johnson Matthey Bank (JMB) episode undermined the credibility of the two-tier system and highlighted the importance of effective corporate governance, culminating in the introduction of the Banking Act 1987. The importance of protecting depositors is enshrined in the Banking Act 1987. Ensuring stability in the financial markets is crucial in preventing the risk of systemic crisis. However, market stability is not enshrined within the statutory remit of the Act in the way depositors' interests are. For example, threat to the interests of depositors present and future is the reason for the revocation or restricting of an authorised institution. In many respects this has created a *prima facie* expectations gap in the regulation of banking institutions because the broader purpose of financial stability is not formally included in the Banking Act 1987. The Act initially gives the impression of safeguarding consumer interests but it also incorporates the regulation and supervision of the wholesale markets.

**Lender of Last Resort & Deposit Protection Scheme**

The role of the Lender of Last Resort (LOLR) is crucial in maintaining confidence in the economy. Its general role is to support institutions in periods of liquidity-pressure, and it has a very long history. Support from the LOLR is informal, and to this date, is not based on any statutory duty. This indicates two things: first, formal rules are not always necessary to determine regulatory action, and secondly, the central bank can operate on the basis of a moral obligation to maintain confidence and does not necessarily require regulatory measures. The advantage in the discretion and opacity of the LOLR is that lack of certainty about when it will intervene means that the market cannot rely on its help, and for this reason, the likelihood of moral hazard in the capital markets is reduced. This is notwithstanding the fact that support from the LOLR inevitably entails some moral hazards. The need for assistance from the LOLR is the result of the failure of regulation and supervision to curtail a risk of systemic contagion. Moreover, it highlights the limited ability of regulation and supervision to prevent such incidents: Regulation and supervision cannot, on their own, determine which behaviours are prudent. Determination in these matters would require the regulator to be active in an institution's commercial decisions and that is not the legal or moral purpose of regulation. This means also that regulation creates as well as curtails regulatory activities based on the idea of prudence. Prudence is not clearly defined and is simply determined by whether or not an institution was compliant with Schedule 3 of the Banking Act 1987. This can only be determined after the event has taken place. Moreover, it may mean that institutions simply increase their provision for bad debts and do not necessarily consider the prudence of taking such risks. This is the case with the over-exposure of the telecommunications industry.

Alternatively, there is the formalised Deposit Insurance Scheme (DIS), a statutory body governed by rules and not standards. The DIS comes into operation when the authorised institution is deemed insolvent. Its existence also provides banking institutions with a sense of safety in the capital markets, even though the remit as to when it is operational is very narrow, covering the financial interests of small depositors rather than wholesale professionals. It is argued that its very existence instils confidence in a market. This is notwithstanding the fact that the LOLR could intervene when the risk of insolvency is present. However, the lack of definition of what constitutes a liquidity or insolvency makes this difficult. In such circumstances, the benefits of averting a breakdown of confidence outweigh the cost of the support operation.

The risk of contagion from the failure or closure of an authorised institution, the interdependent nature of the banking industry requires a cautious approach to enforcement. An enforcement strategy that fails to have regard of wider concerns will surely be deemed counter-productive. The cost of enforcement-decisions could far outweigh the benefits to depositors; the policy of allowing an institution to work through a problem could be more advantageous. Moreover, it could avoid other forms of regulatory intervention if the fallout led to the use of LOLR or to operating the DIS.

**The Banking Act 1987**

Banking regulation has traditionally been framed on a *laissez faire* basis and thus requires the trust and co-operation of the regulated business, without which effective regulation may not be achieved. The regulator has traditionally attempted to distance itself from the day-to-day business decisions of authorised institutions, unless those decisions result in non-compliance. Therefore, whether an authorised institution is profitable is ultimately a governance issue based on the stewardship of the institution. Notwithstanding the autonomous state, regulation and supervision has attempted to build on the traditional roots of verifying the stewardship of the institution as required by any company. This is evident in the use of external auditors and the accountancy profession in the regulatory and supervisory framework.

For centuries, long before regulation existed, the external auditor has been permitted to verify the stewardship of a company. The auditing process is part of the market's need for independently-verified information. The need for regulation and supervision serves a wider purpose than simply providing information to determine investment decisions. Furthermore, a number of the processes undertaken by the external auditor are similar to those undertaken by a regulator. The traditional duty of confidentiality to the client soon came into question with the growing need to maintain the existing order of regulation and supervision. This is based on the importance of maintaining the autonomy of the institution and the need for regulation to be seen as effective. Therefore, the gateway for communicating material misstatements (or other issues of material significance) brought to the fore a quasi-regulatory responsibility beyond the traditional role of verifying the stewardship of the company. The added role of reporting-accountant also supports the wider public role. Again, it culminates from the traditional legitimacy of the work of the auditing profession. It is inevitable that a duty of care arises.

**International Co-operation**

The City of London consists of numerous markets for various financial products. This has added to the attraction of the City, making it a leading centre in terms of capital markets. In many ways the Bank of England's policy of open access and liberal stance on regulation and supervision of these essentially wholesale markets is attributable to the strength of these markets.

Notwithstanding this, banking regulation has been co-ordinated between the Home State and Host State. Participation EU markets requires co-operation between the Home and Host State to safeguard confidence in those markets. The Host State has a responsibility to ensure that the branches of foreign businesses operating in their jurisdiction act in a safe and sound manner. Central to co-operation is the issue of reciprocity. This brings to the fore the problem of balancing one's competitive position and ensuring that the transfer of information assists the effective regulation of internationally active banks. Attempts to open gateways through Memoranda of Understanding have been implemented, and this will require the co-operation of more states to make sure that weak links are not used inappropriately by unscrupulous institutions.

**Financial Conglomeration**

The impact of deregulation has exposed the fragmented and overlapping efforts of the various regulatory bodies. Moreover, it has exposed the different styles of regulation, both rule and discretion based. The Banking Act 1987 developed from one particular traditional approach to regulation and supervision; whereas, the Financial Services Act 1986, the Securities Investment Board had the much more difficult task of co-ordinating a single regulatory and supervisory approach which was to be interpreted in a number of ways by the requisite SROs. It emanated as two distinct forms of regulation, one based on the institution and the other on a functional approach. The dismantling of restrictions on the forms of business one could participate in meant that s institutions were exposed to similar forms of risk. A consequence of this is that regulators have needed to understand the way other forms of risk affect authorisation. This warranted a re-assessment of the way these financial conglomerates were ultimately regulated. Therefore, the single regulatory approach should not come as any surprise.

**The Single Regulatory Approach**

The establishment of the FSA and the introduction of the Financial Servicos and Markets Act 2000 have brought a particular maturity into the method of regulating and supervising 'regulated activities'. The introduction of the FSMA 2000 as the statutory umbrella for a number of previously separately-regulated bodies is no small feat. This could raise the concern that the fusion of banking and investment businesses will result in an increasingly rules-based approach to regulation in which the FSA models itself on a super-SIB regulatory authority. In many respects, the FSMA 2000 consolidates the important attributes of a regulatory system: authorisation, supervision and enforcement. The added objectives and principles provide an underlying context and purpose to those facets of regulation and supervision and are not new in terms of the whole industry. However, with the objectives and principles being the underlying basis for all regulated activities, new concerns will inevitably mean a different approach to the way some activities are regulated and supervised. For example, market confidence and consumer protection are not new to banking supervision, but the formal introduction of consumer awareness is. Furthermore, it will mean the 'securities division' will be required to consider market confidence and the increasing systemic risk that can emanate from investment business.

**Corporate Governance and Senior Management Responsibilities**

Corporate governance is the mainstay of regulation and supervision. In the mid-1990s the importance of corporate governance was r-asserted because of the spate of financial failures in this period. Internal control is one manifestation of good corporate governance. The promotion of corporate governance supports the idea that a response to gaps in regulation need not necessarily be one that brings greater layers of regulation. Moreover, it complements the idea that entrepreneurial spirit should not be stifled with rules. Regulation as a process is not exclusive but dependent on the co-operation of authorised institutions. This process is based on negotiation and concerted effort for developing appropriate rules and standards. It is also important not to simply focus on regulatory failures but rather to take a holistic approach to determine the limits of regulation.

**The Internal Auditor: Watchdog or Bloodhound?**

As noted above, corporate governance requires internal mechanisms to ensure day-to-day compliance. One party that undertakes this task in a broad way is the internal auditor. The internal audit provides the unique service of designing, planning, implementing and revising internal controls. Many of these processes complement, and in some ways mirror, the process of supervision. While the regulator has some insight into the way an authorised institution operates, it cannot have the same insight as an internal auditor's. It is plausible to enhance the position of the internal auditor in the regulatory framework. The audit process *per se* has a number of similarities to the process of regulation and supervision, one being the verification of the accountability of an authorised institution. Therefore, giving the internal auditor a higher profile could provide more insight into the organisation. Moreover, it would enable the organisation to utilise its own resources to correct deficiencies as they are identified.

This could be achieved by imposing a duty on internal auditors to disclose all areas of material significance to the regulator. As a number of institutional failures and losses to depositors show, relying on an authorised institution to audit itself is not always be effective.

This issue needs to be dealt with sensitively by making an institution responsible for ensuring the independence of internal auditor. Disclosure need happen only as a measure of last resort when governance mechanisms are failing. This would correct the old perception of auditors as bloodhounds. Communication with regulators need occur only when the internal auditor believes that senior management has not implemented the material recommendations of an independent audit committee. This would inevitably mean that there is a disclosure of non-compliance when management has not taken appropriate steps to implement measures that the internal auditor and audit committee consider significant. Making internal auditors' duty to report a statutory obligation would obviate the stigma attached to disclosure and denies the scope for labelling an internal auditor a 'whistleblower'.

**Enforcement and Accountability**

While the 1987 Act provided the possibility of implementing a broad range of sanctions, it lacked measures to ensure transparency. The single regulatory approach will end the opacity of the Bank's decision-making, particularly in the area of enforcement. However, it would be premature to predict how the FSA will undertake its powers under the FSMA 2000.

The other side to the regulation coin is the accountability of decision-makers. It is reasonable to argue that accountability needs to be seen to be happening. The public purpose of financial regulation and supervision surely warranted input from the Audit Commission to determine the FSA's effectiveness. The reason for this is that the FSA has a broad range of responsibilities for governing the whole financial industry, and so a broad range of objectives emanate, many of which focus on conduct-of-business rules. While it is premature to say that the FSA will adopt this approach to the regulation and supervision of accepting deposits, it will clearly have to have consumer interests in mind when making decisions. Unfortunately, this may only be exposed when the next bank fails.

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